

# **Corporate Governance in the Banking and Finance Sector**

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# **Corporate Governance in the Banking and Finance Sector**

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## **Abstract**

The focus of this thesis is an examination of certain weaknesses in the corporate governance at UK and US banks which constituted an underlying cause of the crisis. It considers the regulatory responses to these identified weaknesses and assesses to what extent these have led to improvements in corporate governance at banks. This research is based on an examination of all the failures at UK and US banks during and after the crisis, and of its related responses. In addition to UK and US responses, several solutions to the weaknesses

identified at UK and US banks are addressed through EU legislation. The conclusions are that board effectiveness was low due to a lack of knowledge and of challenging of senior management; there was a culture placing growth and profit over risk management; and remuneration was structured leading to unacceptable risk taking resulting in scandals. It is concluded that the mechanisms to limit the impact of a failure of a bank on its stakeholders were inadequate. A case study of the financial crisis in US during the 1990s is undertaken to consider whether the US regulatory response offers lessons to UK regulators and legislators. The finding is that analysis of regulation and corporate governance at banks is problematic. There were similarities between the two financial crises, the organisation and culture of the UK and US banks is so different that different regulatory responses follow.

## **Dedication**

This work is dedicated to my family. CHUNG, Chun-pong Thomas August 2017, acknowledgement the last few years have been a journey beyond my expectations and an amazing learning experience. I have been fortunate to meet a number of inspiring people at the University of Wolverhampton since my LLB in 2001-2006 and LLM in 2006-2008. The willingness to embark in a research degree and to stay in academia stemmed to a high extent from that experience, from the truly exciting lectures I attended and from the joyous study shared with marvellous classmates and teachers. As I resolved to pursue such a lengthy and committing endeavour that is a PhD, I need to thank my supervisors Dr Andrew Haynes and Dr Peter Yeoh for the guidance they provided over the last eight years. I am thankful for

their directions and for the intellectual stimulations that helped me to shape this work. I am indebted to Dr Andrew Haynes, who supervised me for the first several years of my law degree, master of law degree and PhD in Laws and introduced me to the beauty of research work by awakening my motivations. I need to thank Dr Peter Yeoh, my second supervisor, also my LLM supervisor, for always providing useful comments on my work. I am very thankful to Professor Andrew Haynes for the invaluable advice he offered on my research and generally for his continuous interest in my academic development.

Over the past eight years I have been fortunate to interact with a number of interesting classmates. I want to thank everyone who took part in teaching me during 2009-17, for the enriching discussions. Special thanks to Dr Andrew Haynes and Dr Peter Yeoh who supported me and contributed along the way. I need to thank my classmates at University of Wolverhampton for their support over the past sixteen years since I joined the Law School. Finally, thank you to my family for the constant support and to my wife Cassandra Law and my daughter Chung Yucca, for their understanding.

### **The structure of the thesis**

The thesis is divided into five chapters. The structure of the chapters is as follows:

Chapter 1 provides an overview of corporate governance. The discussion begins with the meaning and implications of corporate governance, the duties of directors and the care and skill of the directors. Then it moves to remedies for breach of duty. The meaning of ‘corporate governance’ is considered to be good corporate governance. Following the initial background information, it is necessary to shed some light on difference between legal systems. Finally, the business judgment rule will enter the discussion, as it was also one of the most important rules in corporate governance.

Chapter 2 focuses on the issue of the corporate governance crisis in the banking and finance sector. Financial scandals are explored and rogue trader are discussed as well. The responsibilities of the directors and insider trading are also discussed in this chapter.

Chapter 3 discusses the UK and US regulatory response which took place in UK and in US. It provides a detailed discussion of the Sarbanes Oxley Act, one of the most sweeping and, at the same time, controversial reforms in US legal history. A brief examination of executive pay and corporate integrity and corporate governance reforms give us a more complete picture of the corporate governance reforms, before discussing with Dodd-Frank Wall Street Reform and Consumer Protection Act.

Chapter 4 discusses the role of financial regulation, the corporate governance regulations and guidelines and the role of stakeholders in corporate governance. The examination starts with corporate governance and excessive regulation, public policy, regulation and incentive structures. It is enlightening to go through the regulation in order to avoid repeating the same mistakes.

Finally, chapter 5 will conclude the thesis, by summarizing the most important points of the discussion and highlighting the role of ethics in the modern corporate governance. It is essential to assess the impact of regulations and supervision of corporate governance and re-define the modus operandi of changing the culture of financial regulations through a changed corporate governance approach.

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## **Chapter One**

### **Introduction**

This chapter provides an overview of corporate governance. The discussion begins with the meaning and implications of corporate governance, the duties of directors and the care and skill of the directors. It moves to remedies for breach of duty. The meaning of ‘corporate governance’ is considered to be good corporate governance. Following the initial background information, it is necessary to shed some light on difference between legal systems. The business judgment rule will enter the discussion, as it was the most important rule in corporate governance. This study seeks to research to uncover the corporate governance factors in the banking sector, especially a number of banking case studies in the

US and the UK. Corporate governance gives attention to power struggle issues between the directors, management, and shareholders. Back in the 1930s this arose because of the shift of power from owners to management especially for corporations in the capital markets. Governance involves the alignment of interests among the stakeholders. Corporate governance covers a large number of issues; its inherent processes have not been fully identified and analyzed.<sup>1</sup>

## **Research Issues**

Shareholders regained more influence in the 1980s and 1990s in both the UK and the US with the emergence of more institutional shareholders. We rely on UK's enlightened shareholder approach to look at both US and UK contexts because we have reason to believe that UK is one of a larger economies in the world and its influence cannot be neglected. A number of legal controls strived to ensure that management act within their authority and for the primary interests of the company as whole.

Despite the presence of legislation corporate governance problems continue to haunt the capital markets. This is not something new, as many of the same core problems of lack of transparency and controls, faulty management compensation schemes, and conflicts of interest. This suggests that a further study could be useful to generate expanded insights on how and why such corporate governance issues continue to trouble the corporate sector, and what policy measures can be taken to alleviate the adverse impact of these problems. Understanding the issues raised by corporate governance requires familiarity with the concepts, assumptions and terminology of each of these fields.<sup>2</sup> This thesis seeks answers and explanations on how and why the banking and finance sector is continuously troubled by core corporate governance issues despite the controls provided by both soft and hard laws. It will focus on banking and finance institutions in the capital market. Further justification for the study is made on the grounds that the banking and finance sector is important to the workings of national economies as it provides the fuel for growth.

## **Research Approach**

The doctrinal approach is adopted for this thesis, primarily because of good access to adequate data sources. It depends on secondary data drawn from related academic books, journal articles, and reliable internet sources and uncover corporate governance insights in the banking sector. Banking case studies include those in the US and the UK. This is complemented by primary data drawn from applicable statutes and soft laws. Triangulation of data is achieved through the appropriate use of different perspectives derived from insights generated by the related disciplines of economics, finance, sociology, and politics.

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<sup>1</sup>

Ali, P. and Gregoriou, G., *International corporate governance after Sarbanes-Oxley*, John Wiley and Sons, New Jersey, 2006, p 66.

<sup>2</sup>

B. Minoru Makihara, Chief Executive of Mitsubishi Corporation, cited in Deakin, S. and Hughes, A., "Comparative Corporate Governance: An interdisciplinary Agenda", (1997), *Journal of Law and Society*, Vol. 24. No.1, p 8.

In this thesis, primary and secondary research will both be used. This research will proceed to collect primary data from statutes and regulations. Secondary research can come from either internal or external sources. The proliferation of web search engines has increased opportunities to conduct secondary research. In this thesis, the study is confined to the banking and finance sector in the capital markets to render the examination feasible within the scope of a PhD. The study focuses on corporate governance issues in the banking sector. The study will limit to the scope to particular governance matters including internal or external governance in the banking sector.

### **Meaning and implications**

The corporate form of business allows firms that need capital to obtain it and expand, thereby help the economy.<sup>3</sup> We define corporate governance as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders.<sup>4</sup> We suggested that corporate governance is concerned with the exercise of power over corporate entities.<sup>5</sup> Corporate governance is an expression that was once confined in usage to a rather narrow group of academics, lawyers and boardroom participants. A modern corporation must be able to effectively perform their role as national productivity-enhancing economic actors.<sup>6</sup> The structure of the governance system depends on the fundamental orientation of the firm and the role that the firm plays in society.<sup>7</sup> The structures and laws by which corporations are governed and in some cases misgoverned are matters that have moved into the public arena in a way that almost begins to approach the discourse on civic governance, that is, the government of the state. Corporations make every effort to avoid such regulation, while they steadily become more powerful.<sup>8</sup> This came after a long silence since the publication of the seminal works by Berle and Means and Coase in 1932 and 1937 respectively.

3

Kenneth A. Kim, John R. Nofsinger & Derek J. Mohr, Corporate Governance, third edition, Pearson, 2010, P 10

4

David Larcker, Brian Tayan, Corporate Governance Matters (A closer look at organizational choices and their consequences), second edition, Pearson Education, Inc, 2016, p 7

5

Bob Tricker, Corporate Governance, Principles, Policies, and Practices, third edition, Oxford University Press, 2015, pg. 30.

6

Fратиanni, M., Sarona, P. and Kirton, J., (eds), Corporate, Public and Global Governance: The G8 contribution, Global Finance Series, Ashgate Publishing Ltd, UK and USA, 2007, p 4

7

David Larcker, Brian Tayan, Corporate Governance Matters (A closer look at organizational choices and their consequences), second edition, Pearson Education, Inc, 2016, p 8

8

Berle, A. and Means, G., The Modern Corporation and Private Property, MacMillan, New York, 1939, p 357



Berle adopted a classic shareholder-centered model of fiduciary duties, in which profit maximization for shareholders was to be the guiding principle for directors.<sup>9</sup> Under this model of the corporation, employees had little or no formal role in the corporate governance framework. This has led to modern forms of governance which focus fairly exclusively on the relationship between management and shareholders and on profit maximization for the shareholders. It is based on a tripartite system of directors, shareholders, and auditors.<sup>10</sup> The majority of the corporate governance literature is concerned with the analysis of control structures designed to protect and advance the interest not only of the stakeholders, but of the management as well.<sup>11</sup>

The managers decided upon the running of the corporation whilst the shareholders, though they were the owners, were entitled to receive cash flows. This leads to conflicts between the interests of the shareholders and those of the management.<sup>12</sup> In exercising its limited powers of management, the general meeting is under a similar obligation to company directors in so far as the general meeting must apply its powers for the benefit of the company as a whole. However, the general meeting may not tell board what to do in terms of everyday management decisions. The test to determine whether the general meeting acted for the benefit of the company as whole may be said to be dominated by an objective consideration of whether or not the general meetings' powers were exercised. The justification for the UK approach is that problems had arisen in the UK due to over centralized boards with over powerful Chief Executives, e.g., RBS and Northern Rock. The Higgs proposals do not take the form of regulatory legislation but merely add a new dimension to a UK system of governance based around a voluntary code of compliance. However, these codes are followed because of the fear that legislation would be employed in response by the state and the possible denial of support from the financial community in general. To comply with future EU directives, it is possible that future corporate governance reforms would take the form of legislation.

Financial development seems tied to corporate governance, with more developed financial systems associated with more professional management, more diffuse shareholders, and less ubiquitous family controls. Politicians bent on interventionism may value being able to

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9

Hill J, 'Corporate governance and the role of the employee' in Gollan P & Patmore G (eds), *Partnership at Work: The Challenge of Employee Democracy: Labor Essays 2003* (Pluto Press Melbourne 2003) 114.

10

Kendall, N & Kendall, A, *Real-World Corporate Governance: A Programme for Profit-Enhancing Stewardship* (FT Pitman Publishing London 1998) 16.

11

Mumford, M., "Corporate Governance and Financial Distress: When structures have to change", (2003), *Corporate Governance*, Vol. 11, No.1, p 53

12

Jian Chen, *Corporate Governance in China* (Routledge Curzon Taylor & Francis Group, London and New York, 2005) p10

influence the whole corporate sector with phone calls to a handful of patriarchs.<sup>13</sup> The idea is to see whether they have the resilience to take on financial upheavals or in another perspective whether some inherent weaknesses in these models helps contribute to the crisis in the banking sector. The corporate form of organization of economic activity is a powerful force for growth. The regulatory and legal environment within which corporations operate is of key importance to overall economic outcomes.

Policy makers have a responsibility to put in place a framework that is flexible enough to meet the needs of corporations operating in different circumstances, facilitating their development of new opportunities to create value and to determine the most efficient deployment of resources. Corporate governance requirements and practices are influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, insolvency law, contract law, labor law, tax law and in the case of banks the capital requirements on which the applicable rules are set out in Basel II which in turn are being replaced by Basel III. There is a risk that the variety of legal influences may cause unintentional overlaps and even conflicts, which may frustrate the ability to pursue key corporate governance objectives.<sup>14</sup>

Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. Within that overall framework, the financial aspects of corporate governance are the way in which boards set financial policy and oversee its implementation, including the use of financial controls, and the process whereby they report on the activities and progress of the company to the shareholders.<sup>15</sup> Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring. Definitions of corporate governance on the broader side emphasize that stakeholders and shareholders should share a larger amount of responsibility.

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Randall K. Morck. A History of Corporate Governance around the World (The University of Chicago Press, 2005) p58.

14

Organisation for Economic Co-operation and Development, 'OECD Principles of Corporate Governance', 2004, Preamble, pg. 31, available in the website: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

15

Report of the Committee on the Financial Aspects of Corporate Governance - Cadbury Code (December 1992), section 2.5 & 2.6. Available at: <http://www.cg.org.cn/theory/zlyz/cadbury.pdf>.

This is likely to be due to its allusion to government, which brings a public element into a domain that is considered private.<sup>16</sup> The precise term ‘corporate governance’ seems to have been used first by Richard Eells, to denote the structure and functioning of the corporate polity.<sup>17</sup> Since corporate governance has been a dominant policy issue in the developed market economies. In the transition economies it took some time for corporate governance to climb the ladder of policy priorities, but since the mid-90s it has been one of the most hotly contested issues. In the wake of the Asian Crisis, corporate governance has become a catchword in the development debate.<sup>18</sup> It is a complicated task to define such a wide term as corporate governance, because it covers a large number of distinct legal and economic phenomena. Each adopted definition reflects the special interest of its creator in the field of corporate governance, because every rigorous analysis needs a good definition as a starting point. The absence of any real consensus<sup>19</sup> on the definition is indicative of the complexity of the subject matter. These definitional reveals that the notion of corporate governance is perceived differently from one country to another. The priorities in the debate on the management and control of corporations vary, and its intensity and nature are different depending on the country in which it is taking place.<sup>20</sup>

Apart from a geographical and historical relativity, the discussion is relative to the academic discipline in which it is studied. The literature of law focuses on the powers and duties of several actors involved in the corporate governance system. Economists examine how to minimize the conflicts of interest between these actors, so that a company can be financed and run in the most efficient way.<sup>21</sup> It is important to ensure that the suppliers of finance to corporations will get a return on their investment. A widely used definition, is that corporate governance is a system of rules, which determine how companies are directed and controlled<sup>22</sup>, as it organizes the structures and the mechanisms that are responsible for the

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Lannoo, K., “A European perspective on Corporate Governance”, (1999), Journal of Common Market Studies, Vol. 37, No.2, pg. 271.

17

Eells, R., *The Meaning of Modern Business: An Introduction to the Philosophy of Large Corporate Enterprise*, Columbia University Press, New York, 1960, pg. 106.

18

Berglöf, E. and von Thadden E.L., “The Changing Corporate Governance Paradigm: Implications for Transition and Developing Countries”, (1999), Working Paper No 263, pg. 5, available in the website: <http://eres.bus.umich.edu/docs/workpap-dav/wp263.pdf>.

19

Keasey, K., Thompson, S. and Wright, M., *Corporate Governance: Economic, Management and Financial Issues*, Oxford University Press, Oxford and New York, 1997, pg. 7.

20

Center for European Policy Studies, “Corporate Governance in Europe: Report of a CEPS Working Party”, (1995), CEPS Working Report No. 12, pg. 2

21

Ibid.

22

running of a company. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.<sup>23</sup>

Globalization and market integration in combination with new ownership structures create new challenges for regulators. The underpinnings and objectives of regulation seem to change rapidly, so regulatory coordination needs constant enhancement and regulatory practice further strengthening.<sup>24</sup> Companies are forced to focus on maximizing asset efficiency and shareholder value in an attempt to access funds and increase their opportunities. Corporate governance has been highlighted as one of the most burning issues both in a legal and financial context.

Corporate governance is a dynamic field of study with wide social and economic implications. It should become a priority for every country to minimize the risk of having more and more companies on the verge of collapse due to bad governance. The recognition that good and ethical corporate governance should become a priority will initiate a process of constant improvement, as it will help in raising the standards and making existing structures more effective. Modern corporate governance is about promoting corporate fairness, transparency and accountability. The words of Shleifer and Vishny, corporate governance does not deal only with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment or just with how the corporate owners can be confident that the corporate managers will deliver a competitive rate of return.<sup>25</sup> The focus is on the enhancement of shareholder value and responsiveness to the needs of stakeholders.

The implications for the corporate governance in this thesis are focus on US and UK banking sector. We will examine the banking context and directors' duties as this is important in this thesis and the corporate objective are well mentioned below. Despite there are some difference between the US and UK institutions failure, their failure is due to some similar reasons namely poor management, no sufficient regulations and no regulators who can execute the regulations in a proper way.

## Defining the Company

### What is a Company

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Report of the Committee on the Financial Aspects of Corporate Governance - Cadbury Code (December 1992), section 2.5. Available at: <http://www.cg.org.cn/theory/zlyz/cadbury.pdf>.

23

Organisation for Economic Co-operation and Development, "OECD Principles of Corporate Governance", 2004, Preamble, pg. 11, available in the website: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

24

Spath, C., "Speech by SEC staff: Regulatory Competition, Integration and Capital Markets", (2006), available in the website: <http://www.sec.gov/news/speech/spch102306cc.htm>.

25

Mathiesen, H., *Managerial Ownership and Financial Performance*, PhD dissertation, series 18, 2002, Copenhagen Business School, Denmark, pg. 45.

A company is defined as activities that take place under an entrepreneur, which is less costly than relying on outside markets.<sup>26</sup> This person has the control to direct the employees what to do and it is this existence of control which creates the company. This approach was criticised because it may not be the authority of this person but the contractual relations that bring people together.<sup>27</sup> This criticism led to the development of the theory.<sup>28</sup> There is the real-world entity and there is the legal entity, which is an abstract thing.<sup>29</sup> Consider a group of people that decide to go through the application process to form a company. The legal entity is created, however in the real world little has changed. This observation impacts the following sections, which describe different theories of the existence of companies. All of these theories are in some way problematic once the question is asked what a company is and these theories must be approached with care.<sup>30</sup> There are different theories of existence of the company, including contractual, communitarian and concessionary theories.<sup>31</sup>

## Contractual Theory

The contractual theory<sup>32</sup> forms the basis of corporate law. If one takes the company as a complex set of explicit and implicit contracts, corporate law can enable the participants to select an optimal arrangement of risks and opportunities that are available.<sup>33</sup> Corporate law would play a more important role than for example regulation. There have been many critics of the theory. One line of criticism is that these contracts do not exist, or sometimes only partially.<sup>34</sup> In contractual theory, the company is regarded as an association or aggregation

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<sup>26</sup>

Ronald H. Coase, 'The Nature of the Firm' 4 *Economica* 386

<sup>27</sup>

Armen A. Alchian and Harold Densetz, 'Production, Information Costs, and Economic Organisation' (1972) 62 *American Economic Review* 777

<sup>28</sup>

Michael C. Jensen and William H. Meckling, 'The Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 *J F E* 305

<sup>29</sup>

Nicholas H D Foster, 'The Theoretical Background: the Nature of the Actors in Corporate Social Responsibility' in Stephen Tully (ed), *Research Handbook on Corporate Legal Responsibility* (Edward Elgar 2005) 4-6

<sup>30</sup>

Nicholas H.D. Foster, 'The Journal of Comparative Law: A New Scholarly Resource' (2006) 1 *JCL* 1, 11

<sup>31</sup>

Janet Dine, *The Governance of Corporate Groups* (CUP 2006) 3

<sup>32</sup>

Ronald H. Coase (n 1); Michael C. Jensen and William H. Meckling (n 3); Melvin A. Eisenberg, 'The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of the Firm' (1989) 24 *J Corp L* 819

<sup>33</sup>

Frank H. Easterbrook and Daniel R. Fischel, 'The Corporate Contract' (1989) 89 *Colum L Rev* 1416, 1418

<sup>34</sup>

of individuals, brought together through contractual relations between its members.<sup>35</sup> The conception can be useful to examine the relationship between the board and directors or other internal relationships. It does limit the model to company internal relationships as external parties or regulators are not part of the contracts that make up the company. The company is placed in the sphere of private law and it is regarded as a legal entity.<sup>36</sup> In economic contractual theory, the view is that the individuals inside the company seek to operate with maximum efficiency and to minimise any transaction costs. The concepts are that an individual in the company acts rationally to gain efficiency.<sup>37</sup> The concept of individualism is linked with liberal thought<sup>38</sup> making the working of the company rely on self-correction instead of any regulatory interference. The risk of theory is that it has the potential to create bad companies, by creating companies without morals or social responsibility, with a preference for as little regulation as possible.<sup>39</sup>

Viewing the company as a nexus of contracts allows for different groups to contribute what they are good at whilst reducing overall costs. Shareholders provide capital whilst leaving the management to professional managers and entrepreneurs, providing managers with the objective of maximizing shareholder value to align interests; to manage divergence of interests, fiduciary duties should approximate the bargain investors and managers would reach if there were zero transaction costs. Efficient profit making companies provide many jobs and products or services that consumers want to buy whilst companies in difficulty are more likely to cut corners and provide unsafe working conditions.<sup>40</sup> Corporate social responsibility defined as accountability of management to not only shareholders but also society is problematic, for the company, cannot have social or moral obligations.<sup>41</sup> Managers do not have a contract with society, but with shareholders, their objectives are defined accordingly. This means that recognition of the interests of stakeholders outside the

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Lewis A. Kornhauser, 'The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel' (1989) 89 Colum L Rev 1449, 1452

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Stephen Bottomley, 'Taking Corporations Seriously: Some Considerations for Corporate Regulation' (1990) 19 Fed L Rev 203, 208

36

Michael J Phillips, 'Reappraising the Real Entity Theory of the Corporation' (1994) 21 Fla St U L Rev 1061

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Janet Dine (n 6) 9

38

Bottomley (n 10) 205

39

Joel Bakan, *The Corporation: A Pathological Pursuit of Profit and Power* (2003 Random House)

40

*Ibid.*

41

*Ibid*

company cannot take place because they are not part of the nexus of contracts.<sup>42</sup> The theory together with the dominance of shareholder value to which it is linked, resulted in a social corporation and, by influencing legislation, promoted what can be termed deregulatory globalisation. In the post-crisis UK financial sector there is a shift in the debate: regulation is becoming more intrusive and defining social functions of the banks is becoming more important. The categorisation of theories of existence of the firm<sup>43</sup> can be used in an ante-crisis world, the behaviour of financial institutes and the environment in which they operated can be brought back to the contractual theory. Then, we will discuss the concession and communitarian theory.

## Concession and Communitarian Theory

The concession theory is not the same as communitarian theory. The concession theory views the existence of a company as a concession by the state.<sup>44</sup> The term concession hints at a long history and comes from the time of the rise of the national state when it was at conflict with religious congregations and organisations of feudal origin.<sup>45</sup> The company can exist as a legal entity once granted power by the state. A point of departure is found in *Dartmouth College v Woodward*,<sup>46</sup> in which it was said that a company is an artificial being, possessing those properties which the charter of its creation confers on it. This can be extended to the view that the state grants special advantages, including limited liability and favourable treatment in the accumulation of assets.<sup>47</sup>

The concession theory is that the state may have the opposite objective. It seeks to curtail the company and to thwart rather than facilitate organisational development.<sup>48</sup> Another shortcoming of this approach is that it covers the company as a legal entity, because that a legal entity is granted a status by the state. The state allows companies to operate with minimal interference except that it seeks to ensure that governance structures are good. It

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Peter Muchlinski, 'Implementing the New UN Corporate Human Rights Framework: Implications for Corporate Law, Governance and Regulation' (2012) 22 *Business Ethics Quarterly* 147, 164

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Janet Dine (n 6) 3

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Bottomley (n 10) 207

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John Dewey, 'The Historic Background of Corporate Legal Personality' (1926) 35 *Yale L J* 655, 666

46

*Trustees of Dartmouth College v Woodward* (1819) 17 *US* 518

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Paul G. Mahoney, 'Contract or Concession? An Essay on the History of Corporate Law' (2000) 34 *Ga L Rev* 873

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Gary M Anderson and Robert D Tollinson, 'The Myth of the Corporation as a Creation of the State' (1996) 3 *Int'l Rev L & Econ*

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does so without imposing its own goals upon the company as it does in communitarian theory. The communitarian approach is a basis for regulation. Bottomley introduces constitutionalism which allows the state to regulate corporate governance.<sup>49</sup> The German Corporation Law 1937 changes to the influence of the management board and the board of directors, it prescribes an objective for companies: they must operate to improve the general welfare.<sup>50</sup>

## Corporate Governance

### The Main Theories

The understanding of why companies exist will inform discussion of the theories of corporate governance: the agency theory, the resource dependence and stewardship theory and the stakeholder theory. Consider the control of the company and separation of ownership and control.<sup>51</sup> In the agency theory, the problem is how the dispersed shareholders, in effect the owners, can control the board to look after their property, the company.<sup>52</sup> The shareholders need to create incentives, coined the agency costs, that align the interests of the agent with that of the shareholders. Agency theory was developed in a wider context of corporate governance.<sup>53</sup> It could be extended to cover employer and employees or company and creditors. This theory is related to the theory as the agents are controlled by contractual agreements. The agency theory is related to the transaction cost economics.<sup>54</sup> The firm seeks to minimize transactions costs by undertaking transactions internally rather than externally, thus growing in size. Other researchers have stated that, as

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Stephen Bottomley, 'From Contractualism to Constitutionalism: A Framework for Corporate Governance' (1997) 19 Sydney L Rev 277

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William Conrad Kessler, 'The German Corporation Law of 1937' (1938) 28 Am Econ Rev 653, 661

51

Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (1932, Macmillan)

52

Margaret M. Blair, 'Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century' (1994 Brookings)

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Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (1976) 3 Journal of Financial Economics 305; Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control' (1983) 26 J L E 301; Kathleen M. Eisenhardt, 'Agency Theory: An Assessment and Review' (1989) 14 Academy of Management Review 57

54

Oliver E. Williamson, 'Transaction-Cost Economics: The Governance of Contractual Relations' (1979) 22 J L E 233; Oliver E. Williamson, 'Corporate Governance' (1984) 93 Yale L J 1197



contracts will be incomplete and never cover for every situation.<sup>55</sup> The stewardship theory rejected the assumption of the agency theory<sup>5657</sup>

The stakeholder theory has been promoted by the OECD. The difference with the previous theories at that it no longer assumes shareholder supremacy. It recognises that shareholders are the owners, the theory argues that everyone with an interest in the company should be looked after. The stakeholders include employees, customers and suppliers, but this can be extended to the community and environment in which the firm operates. It shares this broader view of the company sitting within the company's wider environment with the resource dependence theory.<sup>58</sup>

## **Internal and External Corporate Governance**

Corporate governance is split into internal and external corporate governance or controls.<sup>59</sup> Internal controls are internal to the company. One could regard the board as the highest control in the firm, exercising control over the decisions made by senior management.<sup>60</sup> The idea of such internal control mechanisms aligns with agency theory, as the issue of control of the agents by the shareholders could be done by way of performance contracts. External corporate governance<sup>61</sup> can be summarised as the control exerted by the markets over the company. It could be seen as a method of last resort, which becomes active when all the internal control mechanisms have failed.<sup>62</sup> The fight for management with other company's

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Oliver Hart, 'Corporate Governance: Some Theory and Implications' (1995) 105 *The Economic Journal* 678

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Lex Donaldson, 'The Ethereal Hand: Organisational Economics and Management Theory' (1990) 15 *Academy of Management Review* 369; Jay B. Barney, 'The Debate between Traditional Management Theory and Organisational Economics: Substantive Differences or Intergroup Conflict?'

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*Academy of Management Review* 382; Lex Donaldson and James H. Davis, 'Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns' (1991) 16 *Australian Journal of Management* 49;

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Jeffrey Pfeffer, *The External Control of Organisations: A Resource Dependence Perspective* (1978 Harper & Row)

59

James P. Walsh and James K. Seward, 'On the Efficiency of Internal and External Corporate Control Mechanism' (1990) 15 *Academy of Management Review* 421, 423

60

Eugene F. Fama, 'Agency Problems and the Theory of the Firm' (1980) 88 *Journal of Political Economy* 288, 294

61

James P. Walsh and James K. Seward (n 38) 434

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management can be a way to improve performance. A hostile take-over would be an external mechanism to control management. It ties into contractual theory if one regards the implementation of the contracts with minimal transaction as the objective of this external mechanism and large investors and creditors can exercise control over the company.<sup>63</sup>

## The Cadbury Report

Although harmonised principles do exist, what is implemented as a system of corporate governance is country specific. This is focused on the UK, where possible arguments from international reports, such as OECD's report on corporate governance,<sup>64</sup> can inform the debate through comparative analysis. Using both UK and international reports of various time periods, this section outlines what is meant by a system of corporate governance. The OECD published an updated version of its principles<sup>65</sup> in September 2015. The Cadbury Committee defined corporate governance as the system by which companies are controlled.<sup>66</sup> The Cadbury report has been replaced by the UK Corporate Governance Code this definition still stands.<sup>67</sup> To the question Cadbury answers that the 'Boards of directors are responsible for the governance of their companies',<sup>68</sup> whilst the system is completed by adding the remaining actors: the shareholders' role in governance is to appoint directors and the auditors.<sup>69</sup> The Financial Reporting Council is responsible for maintaining high standards of corporate governance in the UK. The Cadbury Report had been folded in to the Combined Code, together with the Greenbury report on remuneration and the Hampel report on the implementation of Cadbury and Greenbury. This Combined Code has been renamed as the UK Corporate Governance Code.<sup>70</sup> It describes the purpose of corporate governance as to

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Eugene F. Fama (n 39)

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Andrei Schleifer and Robert W. Vishny, 'A Survey of Corporate Governance' (1997) 52 J Fin 737, 753

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OECD, OECD Principles of Corporate Governance (Paris, OECD Publication Service 2004)

<<http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf>>

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OECD, G20/OECD Principles of Corporate Governance (September 2015) <<http://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf>>

66

Sir Adrian Cadbury, Report on the Committee on the Financial Aspects of Corporate Governance (London, Gee&Co, 1992) 2.5

67

Financial Reporting Council, 'The UK Corporate Governance Code' (2010) <<https://www.frc.org.uk/getattachment/b0832de2-5c94-48c0-b771-ebb249fe1fec/The-UK-Corporate-Governance-Code.aspx>>

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ibid

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ibid

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facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company.<sup>71</sup>

## International Reports

The OECD, states that employees and stakeholders play an important role in contributing to the long-term success and performance of the corporation.<sup>72</sup> The OECD remains neutral towards the different approaches of corporate governance, in this statement, the contribution of stakeholders to the long-term success of the company is recognised. The OECD provides examples of some important stakeholders. The competitiveness and success of a corporation is the result of teamwork that embodies contributions from a range of different resource providers.<sup>73</sup> Other international reports, which are the result of harmonising different practices across countries, such as Basel II<sup>74</sup> and the Winter Report,<sup>75</sup> use this enlarged definition. The national differences brought together in these international reports concern labour co-determination and whether shareholders should extend their concern from profit maximisation to wider social and environmental issues outside the company.<sup>76</sup> In the UK, the directors do not have a fiduciary duty towards the shareholders. However, in the Companies Act 2006, s172, the directors have to promote the success of the company whilst having regard for employees, suppliers, customers and others as well as impact on the community and environment. Alistair Darling, then Secretary for Trade and Industry, commented that directors will be required to promote the success of the company in the collective best interest of their shareholders, but in doing so they will have to have regard to a wide range of factors.<sup>77</sup>

In the Companies Act 1985, s309, which specified that directors should have regard for the interests of the company's employees and the interest of its members. These sections of the

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Financial Reporting Council (n 47)

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ibid

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OECD (n 44) 12

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ibid

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Basel Committee on Banking Supervision, Enhancing Corporate Governance for Banking Organisations (Bank for International Settlements, 2006)

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Jaap Winter, 'Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe' (Brussels, 4 November 2002) 59 <[http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf)>

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Klaus J Hopt, 'Comparative Company Law' in Mathias Reimann and Reinhard Zimmerman (eds), The Oxford Handbook on Comparative Law (2008 OUP) 1183

77

HC Deb 6 June 2006, vol 446, col 125

Company Act 2006 have been branded enlightened shareholder value as it goes somewhat further than merely shareholder value.<sup>78</sup> Moving away from shareholders towards stakeholders allows for corporate social responsibility, defined as the responsibility towards the company's stakeholders.<sup>79</sup> Consider the difference between the UK's single board and the dual board as is adopted in Germany.<sup>80</sup> If that is possible to say at all given the difficulties in comparing the two. The Companies Act 2006 outlines the responsibilities of directors. These include their fiduciary duties towards the company; although the company can enforce these duties, the shareholders will be able to enforce them through derivatives action.<sup>81</sup>

## Internal and External Corporate Governance at Banks

Corporate governance for banks has several issues including extensive regulation and supervision, debt-governance and a much greater emphasis on risk management.<sup>82</sup> Because of several bank failures, international groups such as the Basel Committee have set out global standards for risk management and capital requirements, such as Basel I<sup>83</sup> and Basel II.<sup>84</sup> Basel I had its shortcomings for political reasons in that it represented the most that the parties involved could agree at the time. It is worth highlighting some of its major deficiencies so that the progress and changes of Basel II can be better understood. Basel III requires banks to improve the quality of capital; in particular tier 1 capital, the highest quality of capital, and to increase the risk that capital needs to cover and to increase the capital requirement ratio itself. Basel III is the reaction to the crisis and therefore is important to this thesis. Differentiating Basel I and II to include Basel III is a reaction to 2008 global financial crisis. The Basel Accord is a global regulatory response. This thesis is

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Peter Muchlinski (n 20) 160

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Domènec Melé, 'Corporate Social Responsibility Theories', in Andrew Crane, Abigail McWilliams, Dirk Matten, Jeremy Moon and Donald S Siegel (eds), *The Oxford Handbook of Corporate Social Responsibility* (OUP 2008) 61

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Government Commission German Corporate Governance Code, 'German Corporate Governance Code' (26 May 2010)

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Patrick Beale, 'Directors Beware?' (2007) 157 NLJ 1033

82

Gottfried Wohlmannstetter, 'Corporate Governance von Banken', in Klaus J Hopt and Gottfried Wohlmannstetter (eds), *Handbuch Corporate Governance von Banken* (Verlag 2011) 67-69

83

Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards' (July 1988) <<http://www.bis.org/publ/bcbs04a.pdf>>

84

Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards: a Revised Framework' (June 2004) <<http://www.bis.org/publ/bcbs107.pdf>>

on US and UK, but both are G20 members with global banks that generally follow this soft law regime.

When discussing the theory of corporate governance, the distinction was made between internal and external corporate governance. This distinction applies for corporate governance at banks. It is complicated because there are additional components to these two areas.<sup>85</sup> The internal corporate governance may include aspects such as a good corporate culture and good ethics and behaviour. The risk management function will play a more prominent role and the role of the Chief Risk Officer is more important. This has implications for the function of the board and how it controls the bank. External corporate governance at banks has the important control by the markets, as is the case with any large company. The agent problem could be extended to include depositors and borrowers; the regulators could play the role of ensuring that the objectives of each of the participants with regards to risk preferences and corresponding incentives are aligned.<sup>86</sup> The regulator needs to balance the interests of the various stakeholders in the economy that can be affected by the risks banks take and the social costs that arise from it. The regulator may be concerned with the moral hazard arising from information asymmetry between the bank and stakeholder: a depositor may not have the same insight in the bank's risk profile as the bank does for the depositor. The point is that regulators should be considered a stakeholder and can play an active role in the agency problem: in the UK, the FCA is playing an active role in designing internal systems at the banks to achieve protection for all stakeholders.<sup>87</sup>

The FSA was created through the Financial Services and Markets Act 2000, or FSMA. This Act superseded the Financial Services Act 1986, which had created the Securities and Investment Board. This regulator replaced various smaller regulating bodies and ended self-regulation. It consolidated the financial regulation into one main body. The name was changed to FSA following the passing of the FSMA. It got regulatory responsibility for mortgage businesses in 2004 and for insurance intermediaries in 2005. It then became the Financial Conduct Authority ("FCA") alongside the Prudential Regulatory Authority<sup>88</sup> ("PRA") set up following the Financial Services Act 2012. Banks are subject to gatekeepers like any company is, such as external auditors. These bring the same concerns for banks as they do for other companies, as ineffective gatekeepers can contribute to failures such as Enron.<sup>89</sup> A category of gatekeepers are the rating agencies. Although these agencies come

<sup>85</sup>

Gottfried Wohlmannstetter (n 81)

<sup>86</sup>

Kern Alexander, 'Corporate Governance and Banks' (2004) 7 *Stud Int'l Fin Econ & Tech L* 245, 249

<sup>87</sup>

<sup>88</sup> Kern Alexander, 'UK Corporate Governance and Banking Regulation: the Regulators as Stakeholder' (2004) 33 *Stetson L Rev* 991,

<sup>89</sup>

Under the supervision of the Bank of England's Monetary Policy Committee

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with many flaws, the ratings they provide hold enormous cloud in the financial markets. These many flaws have contributed to the failure of rating agencies to do their job properly. They are regarded as a contributing factor to the financial crisis and in need of reform.<sup>90</sup>

## The Financial Crisis

Systemic risk can be defined as the risk that the failure of one financial institution can cause or contribute to the failure of other significant financial institutions as a result of their linkage to each other. Systemic risk can be defined as to include the possibility that one exogenous shock may cause or contribute to the failure of multiple significant financial institutions.<sup>91</sup>

There are risks specific to banking that can be addressed by corporate governance and regulation systemic risk is far more difficult to address<sup>92</sup>. The answer may not be to impose higher capital requirements and to reduce the risk appetite of the banks, but in the case of failure, to prevent a widespread crisis of confidence by planning for large external events. Such an argument goes back to Cadbury and other reports on corporate governance, highlighting the importance of internal communication, risk management and the education of senior management and directors. Hopt discusses a range of such improvements to banking corporate governance in great detail<sup>93</sup>. He suggests that stakeholder governance and goals should not be introduced for banks, instead promoting changes such as less opaque structure and group-wide governance to promote risk assessment. As a result of state aid to failing financial institutions, the Western world has seen a return of the state-owned enterprise. Citigroup and AIG, have used state aid provided under the troubled asset relief program (TARP); in the UK financial institutions such as Lloyds and the Royal Bank of Scotland have received capital injections from the government. To have controlling power over financial institutions can trigger various clauses in company and security laws, as is the case in the US, bringing with it many additional complications.<sup>94</sup> The government becomes a controlling shareholder under TARP which implies that it has liability to other

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Peter Muchlinski, 'Enron and Beyond: Multinational Corporate Groups and the Internationalization of Governance and Disclosure Regimes' (2005) 37 Conn L Rev 725 or John Coffee Jr, 'What Caused Enron? A Capsule Social and Economic History of the 1990s' (2004) 89 Cornell L Rev 269

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John Coffee Jr, 'Rating Reform: The Good, The Bad and The Ugly' (2010) ECGI Working Paper Series in Law Number 162/2010 <<http://ssrn.com/abstract=1650802>>

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Hal S Scott, 'The Reduction of System Risk in the United States Financial System' (2010) 33 Harv J L & Pub Pol'y 671, 673

92

Peter O. Mülbert and Ryan D. Citlau, 'The Uncertain Role of Banks' Corporate Governance in Systemic Risk Regulation' (2011) ECGI Working Paper Series in Law Number 179/2011 <<http://ssrn.com/abstract=1885866>>

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Hopt K "Corporate Governance of Banks after the Financial Crisis" (2011) ECGI Working Paper 181/2011

94

J.W. Verret, 'Treasury Inc.: How the Bailout Reshapes Corporate Theory and Practice' (2010) 27 Yale J on Reg 283, 302-307

shareholders. The US is immune from suit unless it has waived this immunity, which it has not under TARP. Contract theory can no longer be applied in government controlled banks and the objective for managers is no longer the generation of profit for shareholders.<sup>95</sup>

## Corporate Objectives

The timeliness and quality of information is the focus of rulemaking in a dynamic framework. The increased availability of relevant, decentralized, and timely information for rulemaking in a dynamic framework can help facilitate rule makers' predictions and anticipation of otherwise unforeseeable contingencies, making anticipatory action by rule makers possible.<sup>96</sup> In May 2000, the European Association of Security Dealers included in its Corporate Governance Principles and Recommendations the aspect that directors must act in the interests of the company and its shareholders as a whole, and went one step forward by adding that stakeholders' rights should be respected and their concerns addressed.<sup>97</sup>

Two years later, the High Level Group of Company Experts repeated that shareholders should ensure that management pursues and remains accountable for their interests and mentioned creditors and made suggestions for their protection.<sup>98</sup> After two more years it was the OECD Corporate Governance Principles, which, after reminding that directors should act in the best interest of the company and its shareholders, pointed out that the interests of the stakeholders should be taken into account with particular emphasis placed upon the effective enforcement of creditors' rights.<sup>99</sup> In 2005 the International Corporate Governance Network asserted that the objective of the corporation, the overriding one, should be to optimize over the long term the returns to its shareholders and, where other considerations affect this objective, they should be stated and disclosed.<sup>100</sup> As a result of this diversity and lack of unanimity on corporate objectives, a polarization has been created. We have countries like

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<sup>95</sup>

ibid 315-318

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<sup>97</sup> Wulf A. Kaal, Dynamic Regulation via Contingent Capital, *Review of Banking and Financial Law*, Vol. 36, 2017, University of St. Thomas, Minnesota - School of Law, 25 Apr 2017, p 9.

<sup>98</sup>

<sup>99</sup> Goldschmidt, L. and Becht, M., EASD Corporate Governance Principles and Recommendations, May 2000, EASD Recommendation No. 00/01, pg. 18, available in the website: <http://ssrn.com/abstract=248089>.

<sup>100</sup>

<sup>101</sup> High Level Group of Company Experts, Final Report On A Modern Regulatory Framework For Company Law in Europe, November 2002, at 47, 87-88, available in the website: [http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf).

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<sup>103</sup> OECD, OECD Principles of Corporate Governance, 2004, at 21, 24, 48, 58, available in the website: [http://www.oecd.org/document/49/0,2340,en\\_2649\\_34813\\_31530865\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,2340,en_2649_34813_31530865_1_1_1_1,00.html)

<sup>104</sup>

<sup>105</sup> ICGN, Statements on Global Corporate Governance Principles, July 2005, at 1.1-1.2, available in the website: [http://www.ecgi.org/codes/documents/revised\\_principles\\_jul2005.pdf](http://www.ecgi.org/codes/documents/revised_principles_jul2005.pdf).

the United States and the United Kingdom supporting that managers should act exclusively in the economic interests of shareholders. The ascertainment of the corporate objective is one of the most important theoretical and practical issues confronting us.<sup>101</sup>

To examine the two theories, the shareholder value theory and the stakeholder value theory, it is worth mentioning that both models have their pros and cons and the choice between the two should not take the form of a right or wrong choice, as it is determined by numerous factors, which can be different for every country.

#### (i) Shareholder value theory

Shareholder value theory puts weight on the long-term economic value of the banking sector. The objective behind corporate decisions should be the promotion of shareholders' interests. Their protection and the enhancement of their investment should be the overriding objective, because if management is allowed or required to pursue any social purpose, managerial accountability to shareholders cannot be secured and shareholders' property rights will be damaged.<sup>102</sup> As Blair points out, a conventional wisdom was developed among economists, finance theorists and policymakers around the globe that shareholder value should be the single, guiding principle of corporate governance, and that enhanced investor control and oversight should be encouraged.<sup>103</sup> Superiority was based on the argument that shareholders have no entitlement to dividends or capital gains; these will be available if the board carries out the company's business successfully. The stakeholders of the company enter into contracts which offer substantial protection to them. Albert Dunlap's phrase encapsulates the essence of shareholder value theory during the 1990s. The most ridiculous word you hear in boardrooms these days is stakeholders. Stakeholders do not pay for their stake. Shareholders do.<sup>104</sup> Perhaps Chainsaw Al's statement was a bit of an exaggeration, but it highlights that there was only one corporate objective and, in any case, multiple objectives were not welcome. He had embraced Friedman's theory that there is only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays in the values of the game.<sup>105</sup>

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Walsh, J., Introduction to the Corporate Objective Revisited Exchange, (2004) 15 Organization Science 349 at 349.

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Letza, S. and Sun, X., Corporate Governance: Paradigms, Dilemmas and Beyond, (2002), Poznan University Economic Review, vol. 2, No 1, pg. 45, available in the website: [www.puereview.ae.poznan.pl/2002v2n1/03-letza.pdf](http://www.puereview.ae.poznan.pl/2002v2n1/03-letza.pdf).

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Blair, M., Shareholder Value, Corporate Governance, and Corporate Performance: A Post-Enron Reassessment of the Conventional Wisdom, in Cornelius, P.K., and Kogut, B., (eds), *Corporate Governance and Capital Flows in a Global Economy*, Oxford University Press, New York, 2003, pg. 56.

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Dunlap, A.J., *Mean Business: How I Save Bad Companies and Make Good Companies Great*, Times Business Books, New York, 1996.

105

Friedman, M., *Capitalism and Freedom*, Chicago University Press, Chicago, 1962.



Shareholder value theory created a new ethos for business and became prominent especially during the second half of the 1990s. In the United States, the courts affirmed the importance of maximizing shareholder value from the early stages. Alastair Ross Goobey, the influential UK fund manager, was of the opinion that as soon as you set more than one benchmark by which you will be judged, there is diffusion of effort and guaranteed disappointment, while Matthew Bishop, Business Editor of *The Economist*, argued in 1994 that making bosses accountable to many stakeholders might make them accountable to none, as there would be no clear yardstick for judging their performance.<sup>106</sup> During the dominance of this theory, share prices reached high levels and the role of managers changed. The agency theory<sup>107</sup> was developed to illustrate the relationship between shareholders and directors. Directors are the agents of the shareholders and are employed to run the company's business for the shareholders who do not have the time or ability to do so, and it is the shareholders who are best suited to guide and discipline directors in the carrying out of their powers and duties.<sup>108</sup> The agency theory was criticized and its conclusions were challenged. There were reservations, concerning the ability of shareholders to discipline directors<sup>109</sup> or the theory's applicability in modern companies<sup>110</sup>.

Dodd expressed the view that managers are free from any supervision from shareholders by reason of the difficulty which the modern shareholder has in discovering what is going on and taking effective measures even if he has discovered it.<sup>111</sup> This view is in line with Berle and Means' assertion that shareholders surrendered a set of definite rights for a set of indefinite expectations.<sup>112</sup> Even if we accept that there was no consensus about shareholder primacy, in practice managers were most times keen on protecting shareholders' interests, preferably large shareholders, since they were the only ones who could become a threat to

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Kay, J., A Stakeholding Society – What Does it Mean for Business?, (1997) *Scottish Journal of Political Economy*, Vol. 44, Issue 4, 425 at 430.

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Among others, Jensen M. and Meckling, W., Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure, (1976) 3 *Journal of Financial Economics* 305; Easterbrook and Fischel, D, pg. 36-39; Fama E. and Jensen, M., Separation of Ownership and Control, (1983), 26 *Journal of Law and Economics* 301; Fama, E., Agency Problems and the Theory of the Firm, (1980) 88 *Journal of Political Economy* 288.

108

Matheson J. and Olson, B., Corporate Law and the Long-term Shareholder Model of Corporate Governance, (1992) 76 *Minnesota Law Rev* 1313 at 1328.

109

Keay, A., Company Directors Behaving Poorly: Disciplinary Options for Shareholders, (2007) *Journal of Business Law* 656.

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Frug, G., The Ideology of Bureaucracy in American Law, (1984), 97 *Harvard Law Rev* 1276 at 1307.

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Dodd Jr, E.M., For Whom Are Corporate Managers Trustees, (1932), 45 *Harvard Law Rev* 1145.

112

Berle, A.A. and Means, G.C., *The Modern Corporation and Private property*, Hacourt Brace, 1932.

their jobs. Apart from the threat of replacement, directors had to consider another threat: if shareholders' interests were not adequately protected, they could withhold capital and refuse to invest.<sup>113</sup> The result was the retention by shareholders of a rather anachronistic perception that companies, especially public ones, should be run predominantly in their interest.<sup>114</sup>

Managers took advantage of their powers to the detriment of shareholders and stakeholders, but instead of focusing on the fraudulent personality of these managers, it would be more useful to continue with the examination of the shareholder value theory. The reason is that shareholder value theory does not limit the managers' powers and discretion at all, it reinforces them. They had claimed that shareholder value theory is mistaken and leads to a dead end. Shareholders have lost control over their companies, because they have traded it for liquidity and the prospects of increased profits. Courts do not have the capacity to judge for themselves the merit of managers' decisions, while gatekeepers, most of the times, can only monitor a company's behaviour ex post and fail to guarantee the transparency of capital markets.<sup>115</sup>

Capital markets are unstable and can be manipulated, so companies are vulnerable, when their managers show blind confidence in the markets, not to mention when they confuse shareholder value maximization with misappropriation of wealth. By impeding a company's ability to make credible commitments not to expropriate stakeholders, the mechanisms which bind managers to shareholder value, created an environment in which companies were less able to establish an effective basis for long-term productive results.<sup>116</sup> The stories of Enron, WorldCom and Parmalat show that if everything is reduced to a matter of profit, shareholder value tends to ignore reality because it is not only the interests of shareholders that are at stake.<sup>117</sup> In the USA, the biggest supporter of the shareholder value theory, none of the states has a statute that imposes a duty on companies to maximize profits at any cost or that makes profit-maximization the sole purpose of the companies.<sup>118</sup> In Delaware, the land of incorporations, the courts have, through their case law, have explicitly state that stockholder

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Bainbridge, SM., In defence of the Shareholder Wealth Maximization Norm: A Reply to professor Green, (1993), 50 Washington and Lee Law Review 1423.

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Kershaw, D., *Company Law in Context: Text and Materials*, Oxford University Press, Oxford, 2009, pg. 325.

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Agglieta, M. and Reberieux, A., *Corporate Governance Adrift: A critique of Shareholder Value*, Edward Elgar, Cheltenham and Massachusetts, 2005, pg. 261-2.

116

Armour, J., Deakin, S. and Konzelmann, S., Shareholder primacy and the Trajectory of UK Corporate Governance, (2003), British Journal of Industrial Relations, 41:3, pg. 541.

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Freeman R. E., Wicks A. and Parmar, B., Stakeholder Theory and the Corporate Objective Revisited, (2004) 15 Organization Science, 364; Allen W., Jacobs J. and Strine, L., The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide, (2002) 69 UChi Law Rev 1067 at 1083

118

interests are not a controlling factor. The statutes provide that the company's management team and directors have the duty to comply with the law, even if that means that they are losing money or they may have reduced profits. Other constituencies' interests will be considered only if, the protection of those interests promotes the interests of the shareholders.<sup>119</sup>

In listed or multinational companies, profit is a rather impersonal concept and belongs to the corporation.<sup>120</sup> Shareholders end up receiving only a part of the share that comes back to the company, following the payment of salaries and all other obligations. As Easterbrook and Fischel pointed out, shareholders are the residual claimants to the firm's income and that's why they have voting rights unlike creditors and employees accompanied with the appropriate incentives to make discretionary decisions. Scholars had recognized this inequality before the end of the previous millennium, but nobody supported the groundbreaking idea of giving rights of control over the board of directors to the employees as well as the shareholders.<sup>121</sup>

## (ii) Stakeholder value theory

The seeds of this theory can be traced back to the 1930s in the famous Dodd – Berle debate about the role and purpose of companies.<sup>122</sup> Berle suggested that managerial powers are held in trust for stockholders as sole beneficiaries of the corporate enterprise<sup>123</sup>, while Dodd was of the opinion that the bank should be viewed as an economic institution which has a social service as well as a profit-making function and that company directors are guardians of all the interests which the corporation affects and not merely servants of its absentee owners. The benchmark text for the stakeholder approach is the study undertaken by Freeman in 1984 describing partners as any group or individual who can affect or is affected by the

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Elhauge, E.R., *Sacrificing Corporate Profits in the Public Interest*, (2005), 80 New York University Law Review 733-869 at 738.

119

Davies, P., *Enlightened Shareholder Value and the New Responsibilities of the Directors*, (2005) Inaugural WE Hearn Lecture, University of Melbourne Law School, pg. 5

120

Bernstein, P., *Profit Theory – Where do we go from here?* in Blumner, S., *Readings in Microeconomics*, International Textbook Company, Scranton, 1969, pg. 243.

121

Among others, Romano, R., *Corporate Law and Corporate Governance*, (1996), *Industrial and Corporate Change* 5, 277-339 at 293.

122

See Clarke, A.D., *The Models of the Corporation and the Development of Corporate Governance*, (2005), available in the website: <http://www.austlii.edu.au/au/journals/BondCGeJ/2005/2.pdf>.

123

Berle, A., *Corporate Powers as Powers in Trust* (1931) 44 Harv L Rev 1049.

achievement of the organization's objectives.<sup>124</sup> The vagueness of the definition of stakeholders as groups in relationships with an organization attracted severe criticism for broadening the scope of stakeholders and, as Sternberg maliciously noted, it included "Everyone, everything, everywhere"<sup>125</sup>. It is dangerous and unjustified, on the basis that it undermines private property, denies agents duties to principals, and destroys wealth. Despite a certain degree of ambiguity in defining the groups of stakeholders, which can create significant problems in implementation<sup>126</sup>, there are several interesting aspects that need to be considered and, most importantly, it introduced a different approach in the corporate object discussion.<sup>127</sup>

Stakeholder primacy supports the inclusion and broader accountability of all parties that can affect or be affected by a bank's activities, as no group that has contributed to corporate success should go unrecognised.<sup>128</sup> The objective of company law should be modified to accommodate a wider range of interests. The bank is a constellation of cooperative and competitive interests possessing intrinsic value.<sup>129</sup> Stakeholder value theory encourages long-term strategy and investment, by promoting ethical, social and environmental responsibility. The success of the bank is dependent on the satisfaction of the stakeholders. Stakeholder management is seen both as an end and as a means.<sup>130</sup> As Carroll illustrates in his book, banks must live up to four levels of responsibility: economically, be profitable and satisfy consumer demand; legally, obey the law; ethically, do what is fair and just and avoid harm; and philanthropically, be involved in charitable giving and community activity.<sup>131</sup> Strong supporters of the stakeholder model consider it as the implementation of a truly caring type of management. They believe that modern society is calling for an increased

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Freeman, R.E., *Strategic Planning: A Stakeholder Approach*, Pitman Publishing, Boston, 1984, pg. 46.

125

Sternberg, E., The Defects of Stakeholder Theory, (1997), *Corporate Governance: An International Review*, Vol. 5 Issue 1, pg. 4.

126

Dodd, E., Is Elective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?, (1934) 2 U Chi L Rev 194 at 199.

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Beauchamp, T.L. and Bowie, N.E. (eds), *Ethical Theory and Business*, 5<sup>th</sup> ed., Prentice Hall, New Jersey, 1997, Ch 2. Also Plender, J., *A Stake in the Future: The Stakeholding Solution*, Nicholas Brealey, London, 1997.

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Dean, J., Stakeholding and Company Law (2001), 22 Company Lawyer 66 at 67.

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Donaldson T. and Preston, L., The Stakeholder Theory for the Corporation: Concepts, Evidence, Implications, (1995), 20 Academy Management Review 65 at 66.

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Emphasizing Responsibility over Profitability: Explaining Stakeholder Value Perspective, available in the website: [www.12manage.com/methods\\_stakeholder\\_value\\_perspective.html](http://www.12manage.com/methods_stakeholder_value_perspective.html) .

131

Carroll, A., *Business and society: Ethics and stakeholder management*, 2<sup>nd</sup> ed., South-Western Publishing, 1993, pg. 32-33.

sense of community, so those in business must understand the needs all companies have and attempt to meet those needs as much as possible. In a changing society, managers must be prepared to change in all areas, not just those dealing with the market.<sup>132</sup>

Clarkson argued that the economic and social purpose of the corporation is to create and distribute wealth and value to all its primary stakeholder groups, without favouring one group at the expense of others.<sup>133</sup> Stakeholders' interests do not exist in isolation. Big and well-established companies are better placed to implement and benefit from stakeholder value than small or newly formed companies. The relevant stakeholders vary from one company to another.<sup>134</sup>

Stakeholder theory grants extensive powers to managers as the only restraints to their decision-making freedom come from forces outside the company, i.e. the financial markets, the market for corporate control and, when all else fails, the product markets.<sup>135</sup> As Jensen puts it, there is no principled way within the stakeholder construct that anyone could say that a manager has done a good or bad job.<sup>136</sup> An employee can simultaneously be a shareholder, a consumer, or can be affected by the environmental impact of the company. Having more than one interest means that this person will sooner or later be faced with the problem of deciding between them. To paraphrase the old adage, when there are many masters, all end up being short-changed.<sup>137</sup> Without the clarity of a mission provided by a single-valued objective function, companies embracing stakeholder theory will experience managerial confusion, conflict, inefficiency, and perhaps even competitive failure. When there are conflicts of interests, a choice has to be made and the stakeholder theory offers no help in

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Burton, B. and Dunn, C., Stakeholder Interests and Community Groups: A New View, (1996), International Association for Business and Society Annual Meetings, available in the website: <http://www.rohan.sdsu.edu/faculty/dunnweb/pubs.iabs96.html>.

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Clarkson, M., A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance, (1995) 20 Academy Management Review 92 at 112.

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Kiarie, M., At crossroads: Shareholder Value, Stakeholder Value and Enlightened Shareholder Value: Which Road Should the United Kingdom Take?, (2006), International Company and Commercial Law Review, Vol. 17, No.11, 339.

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Jensen, M.C., Value Maximization, Stakeholder Theory, and the Corporate Objective Function, (2001) in Andriof, J., et al (eds), *Unfolding Stakeholder Thinking*, Greenleaf Publishing, 2002, pg. 14.

136

Ibid.

137

Jensen, M.C., Value Maximization, Stakeholder Theory, and the Corporate Objective Function, (2001), 14 Journal of Applied Corp. Fin. 8 at 9.

making that choice.<sup>138</sup> There is no clear yardstick by which to judge their performance.<sup>139</sup> This leads to the potential for directors to engage in opportunistic behaviour, namely taking the chance to benefit themselves at the expense of others, because they end up accountable to no one.<sup>140</sup> A total lack of equitable control can lead to fraudulent practices because, as Berle and Means have noted, managers can serve their pockets better by profiting at the expense of the company than by making profits of it.<sup>141</sup>

## Enlightened Shareholder value

Enlightened shareholder value (ESV) is intended to apply as a generic statement of duties for directors of companies of every size.<sup>142</sup> As stated by the Committee on Trade and Industry, the ESV approach towards defining directors' duties maintained that the primary duty of a company director was to maximize value for the company's shareholders. The interests of employees, customers, suppliers, and local residents, as well as the environmental impact of the company's activities and its good standing in the eyes of the public, all had to be considered when judging what was in the interests of shareholders.<sup>143</sup> Even if we go back in time and remember the words of Bowen LJ in 1883, who said that the law does not say that there are to be no cakes and ale except such as are required for the benefit of the company<sup>144</sup>, it is obvious that directors had the discretion to take account of stakeholders' groups when promoting the interests of the company.

Sir Adrian Cadbury was the first to speak about finding the equilibrium among all the competing considerations: long-term and short-term notions of gain, cash and accounting

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Black, A., Wright, P., Bachman, J. and Davies, J., *In search of shareholder value: Managing the drivers of performance*, Pitman Publishing, United Kingdom, 1998, pg. 14.

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Final Report of the Committee on Corporate Governance (Hampel Report), January 1998, para 1.17, available in the website: [http://www.ecgi.org/codes/documents/hampel\\_index.htm](http://www.ecgi.org/codes/documents/hampel_index.htm).

140

Keay, A., Ascertaining the Corporate Objective: An Entity Maximisation and Sustainability Model, (2008), *Modern Law Review*, Vol. 71, Issue 5, 663 at 676.

141

Banks, E., *Corporate Governance: Financial Responsibility, Controls and Ethics*, Palgrave MacMillan, New York, 2004, pg. 23.

142

Committee on Trade and Industry, Sixth Report, 2001, pg. 11.

143

*Ibid*, pg. 13.

144

*Hutton v West Cork Railway Co* (1883) 23 ChD 654, CA.

concepts of value, democracy and authority, power and accountability.<sup>145</sup> In his classic book<sup>146</sup>, he identified three levels of company responsibility. The primary level comprises the company's responsibilities to meet the material obligations to shareholders, employees, customers, suppliers and creditors, to pay taxes, and to meet its statutory duties. The second level includes the direct results of a company's actions in carrying out their primary task, regarding for example the environment and the community's human resources. The last level includes the interaction between the company and the society in a wider sense. Profit maximisation remains the objective of the company but is subject to developing relationships of trust with shareholders, as this is the best way to ensure sustainability and secure overall prosperity and welfare.<sup>147</sup> ESV retains a director-centric character and gives directors a broad discretion to add stakeholders' interests and other broader factors to the traditional shareholders' interests. It is neither altruistic nor wealth-sacrificing theory; it just places its focus on generating long-term shareholder wealth through investor and management attention to the company's impact on extended stakeholder constituencies.<sup>148</sup> Stakeholders' interests become part of the decision-making process, but they do not actively participate in it nor do they have a direct voice or the opportunity to express their views. Directors should be able to balance the competing interests for the benefit of all contributors and not just shareholders.<sup>149</sup>

Directors are required to only consider the interests of other stakeholders and only when in honest pursuit of the promotion of the success of the company for the benefit of its members. The objective of all healthy organizations is to create a framework which is economically, ethically and socially responsible and sustainable.<sup>150</sup> Even the Hampel Report, which is considered to be an endorsement of shareholder value, mentions stakeholders' interests as relevant to the company's success together with the presentation and the enhancement of the shareholders' investment.<sup>151</sup> By adopting measures necessary to maximize corporate value, a

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Monks, R. and Minow, N., *Corporate Governance*, 4<sup>th</sup> ed., John Wiley and Sons, UK, 2008, pg. 75.

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Cadbury, A., *The Company Chairman*, Director Books, Hertfordshire, 1990.

147

Gamble, A. and Kelly, G., Shareholder value and the Stakeholder Debate in the UK, (2001), *Corporate Governance*, Vol. 9, Issue 2, pg. 111.

148

Harper Ho, V., *Enlightened Shareholder Value: Corporate Governance Beyond The Shareholder Stakeholder Divide*, (2010), pg. 36, available in the website: [http://works.bepress.com/virginia\\_ho/2](http://works.bepress.com/virginia_ho/2)

149

Ibid.

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Hermes Principles by Hermes Pensions Management Limited, October 2002, available in the website: <http://www.hermes.co.uk>cg>policies>.

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company can advance the interests of stakeholders as well as the interests of shareholders. John Kay pointed in the right direction by saying that it is sensible to consider adapting the corporate model to reality rather than reality to the model.<sup>152</sup> ESV should not be rejected *a priori*, the basic concept behind its emergence of ESV was to the creation of a strong combination of the two existing models, a hybrid with superior characteristics. It is erroneous to criticize ESV as a mere re-branding of a shareholder value adapted to placate the increasingly concerned stakeholder community.<sup>153</sup> It puts emphasis on the long-term sustainability of the firm and the need for relationships of trust, while maintaining efficiency and accountability accruing from the profit maximization goal.

Stakeholders' interests are taken into consideration significantly more than before, and shareholders continue to have profit maximization as their main goal. Kay has talked about the Entity Maximisation and Sustainability Model (EMS), which focuses on an objective, instead of people or certain groups. Entity maximisation does not focus solely on profit maximisation, for it encompasses such things as augmenting reputation, which can be seen as the most important asset of a company.<sup>154</sup> Directors do not have to engage in active balancing between investors' interests as their aim is to maximise entity wealth: to increase the overall long-run market value of the company as a whole. Team Production (TP), was developed a few years earlier in 1999 by Blair and Stout but differs from EMS in that it requires directors to look after the investors' interests.<sup>155</sup>

Kay in 2002 claimed that the challenge was to develop a genuinely inclusive capitalism, that involves differences in the way companies behave, markets operate and business is regulated. In his model, shareholder return is the result, not the objective, of successful business; in which securities markets are mechanisms for financing and refinancing companies rather than hyperactive casinos; in which employees and investors have the objectives of satisfying customers and outperforming competitive products; in which the regulation of business is designed to enforce on a minority the behaviour which most people adopt naturally.<sup>156</sup> The theories and models are useful and thought provoking contributions. There is room for improvement and the greatest challenge is to provide a clear answer on

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Smerdon, R., *A Practical guide to corporate governance*, 2<sup>nd</sup> ed., Sweet and Maxwell, London, 2004, pg. 10.

152

*Ibid.*, pg. 8.

153

Response of the CORE Coalition to the 2005 Company Law White Paper: Delivering Company Law for all Stakeholders, available in the website: <http://www.dti.gov.uk>.

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Dean, J., *Directing Public Companies*, Cavendish, London, 2001, pg. 107

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Blair M. and Stout, L., A Team Production Theory of Corporate Law (1999), 85 Va LR 247 at 258259. See Alchian, A., and Demsetz, H., Production, Information Costs and Economic Organization, (1972), 62 American Economic Review 777.

156

Kay, J., Stakeholding Misconceived, Financial Times, 12 February 2002, available in the website: <http://www.johnkay.com/2002/02/12/stakeholding-misconceived/>



how each one of them could be enforced in practice and how they could have a positive influence on the transformation of the corporate decision-making process. The debate on the merits of being on one side or another of this great divide or taking the third new way has been, and will no doubt continue to be, long and hard, with predictions that one arrangement would triumph over the other in a fast-changing world.<sup>157</sup> The ESV approach is a good basis for discussions and it represents a hybrid model, which, if properly developed, can become functional and workable. Once directors and managers are convinced that such prescriptions are not wet, woolly and vacuous<sup>158</sup>, the road will be open for the creation of well-governed companies, capable of achieving long-term success and sustainable development; companies which will aim to satisfy customers, increase employee responsibility and empowerment and create stable, trust-based supplier relations, all with a view towards generating value for the firm in the long run.<sup>159</sup>

## Internal and External Governance

Most of the corporate governance literature focuses on external mechanisms for limiting managerial discretion: competition in product and factor markets; discipline from banks, institutional investors, and other large capital suppliers; and the market for corporate control. Firms have access to internal control mechanisms as well-performance-based pay, internal audits, a strong Board, competition among the top-management team, but these are considered weaker, less effective instruments.<sup>160</sup> The arrangements of corporate governance would provide for a management structure with clear lines of accountability; independent non-executive directors on the board, an independent audit committee, the risk profile of the bank; transparent ownership structure, internal structures that enabled the risk profile of the bank to be clear, transparent and managed; and monitored risk analysis and management systems. A key conclusion is that including through regulation and supervision, mechanisms are needed for the creation of appropriate incentives for all the major players including regulators and supervisors.<sup>161</sup> There are distinct limits to what regulation and supervision can achieve in practice. It must be recognised that, there is no viable alternative to placing the main responsibility for risk management on the shoulders of the management of financial institutions. External regulation and supervision by official agencies must not be viewed as

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<sup>157</sup>

Davies, P., *Introduction to Company Law*, Clarendon Law Series, Oxford University Press, Oxford-New York, 2002, pg. 281.

<sup>158</sup>

Kay, J., *The Business of Economics*, Oxford University Press, Oxford, 1996, pg. 86.

<sup>159</sup>

Pichet, E., Enlightened Shareholder Theory: Whose interests should be served by the supporters of Corporate Governance?, (2008), pg. 13, available in the website: <http://ssrn.com/abstract=1262879>

<sup>160</sup>

<http://organizationsandmarkets.com/2009/12/07/internal-and-external-corporate-governance/>

<sup>161</sup>

Effective regulation and supervision of banks and financial institutions has the potential to make a major contribution to the stability and robustness of a financial system.

an alternative to robust and effective internal supervision processes and responsibilities. The lessons of banking crises are that there needs to be more effective surveillance of financial institutions both by supervisory authorities and the markets. As directors are important to run the company, we are therefore going to consider the obligations on directors.

### **Promoting company success**

Corporate benefit: to promote the success of the company for the benefit of its members as a whole. The company sets out some factors to which a director must have regards in fulfilling the duty to promote success.<sup>162</sup> Company Act 2006 also codify directors' duties. These are the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct, and the need to act fairly as between members of a company. Previously in the United Kingdom, under the Companies Act 1985, protections for non-member stakeholders were more limited which permitted directors to take into account the interests of employees but that could be enforced only by the shareholders, and not by the employees themselves.<sup>163</sup> Directors must act honestly and in bona fide. Difficult questions arise when treating the company too abstractly. It may benefit a corporate group as a whole for a company to guarantee the debts of a sister company, even if there is no benefit to the company giving the guarantee. There is no benefit to a company in returning profits to shareholders by way of dividend. The more pragmatic approach normally prevails.<sup>164</sup> Directors are not required by the law to live in an unreal region of detached altruism and to act in the vague mood of ideal abstraction from obvious facts which must be present to the mind of any honest and intelligent man when he exercises his powers as a director.<sup>165</sup>

We might have a lunatic conducting the affairs of the company and paying away its money with both hands in a manner perfectly bona fide perfectly irrational. It is for the directors to judge, provided it is a matter which is reasonably incidental to the carrying on of the business of the company. The law does not say that there are to be no cakes and ale, but there are to be no cakes and ale except such as are required for the benefit of the company.<sup>166</sup>

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<sup>162</sup>

s.172 CA 2006

<sup>163</sup>

s.309 CA 1985

<sup>164</sup>

Mills v. Mills (1938) 60 CLR 150

<sup>165</sup>

Hutton v. West Cork Railway Co (1883) 23 Ch D 654, per Bowen LJ

<sup>166</sup>

## Care and skill

Duty of care: the level of care and skill a director must demonstrate has been framed largely with reference to the non-executive director. It was expressed in purely subjective terms, where the court held that a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience.<sup>167</sup> This decision was based firmly in the older notions that prevailed at the time as to the mode of corporate decision making, and effective control residing in the shareholders; if they elected and put up with an incompetent decision maker, they should not have recourse to complain. However, a more modern approach has since developed, the court held that the rule in *Re City Equitable Fire Insurance Company* related only to skill, and not to diligence.<sup>168</sup> It has been suggested that both the tests of skill and diligence should be assessed objectively and subjectively;<sup>169</sup> in the United Kingdom the statutory provisions relating to directors' duties in the new Companies Act 2006 have been codified on this basis.<sup>170</sup> Care and skill include in effect the duty not to fetter a director's discretion and lack of independence. A director owed the duty of care once the company is insolvent or nearing insolvency. It is still the company until all the procedure is completed.

Individual directors with relationships to management or to a significant shareholder are by definition not considered to be independent; however, the absence of such relationships does not guarantee independent judgment. Such definitions vary from jurisdiction to jurisdiction and reflect different approaches to the drafting of codes of governance. These principles underline the importance of all directors being independent-minded which means exercising objective judgment in the best interests of the corporation in all circumstances regardless of the consequences which such judgment may have for the director personally.<sup>171</sup> Each board

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Boulting v Association of Cinematograph, Television and Allied Technicians [1963] 2 QB 606

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*Re City Equitable Fire Insurance Co* [1925] Ch 407

<sup>168</sup>

*Dorchester Finance Co Ltd v Stebbing* [1989] BCLC 498

<sup>169</sup>

s.174, CA 2006

<sup>170</sup>

*Re Barings plc (No.5)* [1999] 1 BCLC 433, *Re D'Jan of London Ltd* [1994] 1 BCLC 561

<sup>171</sup>

Every corporation should disclose its definition of independence and should disclose its determination as to each member of its board of directors whether such member is independent.

should include a strong presence of independent non-executive directors with appropriate competencies including key industry sector knowledge and experience. Each board may include a minority of directors who are non-executive directors and who are not independent but who may effectively discharge their responsibilities as directors because of a relationship with the corporation or past experience with the corporation. Where committees of the board are established, their remit, composition, accountability and working procedures should be well-defined and disclosed by the board. All corporations should establish the key committees of the board which include the audit, compensation and nomination / governance committees. At least a majority and, preferably all members of the audit committee should be independent. The compensation and nomination / governance committees should be composed of a majority of independent directors. Every corporation should have a process for reviewing and monitoring any related party transaction. A committee of independent directors should review every related party transaction to determine whether such transaction is in the best interests of the corporation and if so, ensure that the terms of such transaction are fair to the corporation.<sup>172</sup>

### **Loyalty and conflicts of interest**

Duty of loyalty and conflict of interest: directors owe strict duties not to permit any conflict of interest or conflict with their duty to act in the best interests of the company. This rule is so strictly enforced that, even where the conflict of interest or conflict of duty is purely hypothetical, the directors can be forced to disgorge all personal gains arising from it, see also Volcker report and Walker Review. Lord Cranworth stated in his judgment in *Aberdeen Ry v. Blaikie*<sup>173</sup> that a corporate body can only act by agents, and it is the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal. So strictly is adhered to that no question is allowed to be raised as to the fairness or unfairness of the contract entered into.<sup>174</sup> It is a rule of universal application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has, or can have, a personal interest conflicting or which possibly may conflict, with the interests of those whom he is bound to protect and we should consider that is often a case of stating their conflict and getting the consent of the majority.<sup>175</sup>

### **Ring-Fencing**

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The corporation should disclose details of all material related party transactions in the annual report of the corporation.

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(1854) 1 Macq HL 461

<sup>174</sup>

Regal (Hastings) Ltd v Gulliver [1942] All ER 378, Cook v Deeks [1916] 1 AC 554, Industrial Development Consultants Ltd v Cooley [1972], Dorchester Finance Co Ltd v Stebbing [1989] BCLC 498, Foster Bryant Surveying Ltd v Bryant [2007] EWCA Civ 200, O'Donnell v Shanahan [2009] EWCA Civ 751

<sup>175</sup>

Ring-fencing made it into statute by way of the Financial Services (Banking Reform) Act 2013, of which ss1-12 needs to be implemented by 2019. It has been the subject of a consultation paper by the PRA.<sup>176</sup> The one criticism of ring-fencing that is difficult to argue against is that its implementation will be riddled with problems. It will be difficult to define in regulations how this fencing has to work exactly. It requires a complete overview of all the different entities under a banking group as well as an overview of all the capital residing in or allocated to each entity. These entities would have to be separated based on whether they are inside the fence or not. The capital would have to be distributed and the flow of capital between the entities, or simple reallocation, would have to be closely monitored. Considering some banking groups consist of at least hundreds of different legal entities, this is difficult at best and, in case of a bank failure, open to endless challenges in the courts. In the daily running of the ring-fenced bank, how intrusive would the PRA and HM Treasury be prepared to become. The question is how UK banks will respond to the ring-fence requirements. Originally, HSBC, which has a large part of its operation overseas, is reported to consider moving its headquarters out of the UK to Hong Kong,<sup>177</sup> however, they later changed their plan that they were not going to do this and they are about to open a new office in Birmingham to hold the non investment part of the bank. Such a move might include the sale of its UK retail branches but in any event, would circumvent the ring-fencing requirement and the bank levy on its balance sheet. Overseas banks with a retail operation in the UK are considering to move their non-retail activities out of the UK.<sup>178</sup> It appears that the Treasury might be giving in to the pressure and water down the ringfencing requirements.<sup>179</sup> It should be noted that monitoring ring-fencing would take up considerable resources of the regulator. This would take time and resources away from other areas of supervision.

Rules and guidelines must be provided on how to deal with any technological infrastructure needed for both parts of the bank. It must be clear how the ring-fenced bank can continue to rely on the infrastructure when it is owned by the other part of the bank. This could be done by way of service agreements or by a form of separation of internal service providers from

s.175 CA 2006, *Keech v. Sandford* (1726) Sel Cas. Ch.61, *Aberdeen Railway v. Blaikie* (1854) 1 Macq HL 461, per Lord Cranworth

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Prudential Regulation Authority, 'Consultation Paper CP19/14 The Implementation of Ringfencing: Consultation on Legal Structure, Governance, and the Continuity of Services and Facilities' (Oct 2014) <<http://www.bankofengland.co.uk/pr/Documents/publications/cp/2014/cp1914.pdf>>

177

The Sunday Times, 'HSBC threat may torpedo plan to break up banks' (17 May 2015) <<http://www.thesundaytimes.co.uk/sto/business/Finance/article1557065.ece>>

178

Sky News, 'Santander sounds alarm over bank ring fencing' (23 January 2015) <<http://news.sky.com/story/1413672/santander-sounds-alarm-over-bank-ring-fencing>>

179

The Sunday Times, 'Ring-fencing zeal wilts after banks' threat to quit Britain' (24 May 2015) <<http://www.thesundaytimes.co.uk/sto/business/Finance/article1559833.ece>>

the banks. There is a need to keep the migration process as short and cost-effective as possible. The regulators' usual tools such as stress-testing are not best suited to test potential legal challenges to ring-fencing. It would be possible for banks to extend their recovery and resolution plans to include scenarios where legal challenges are made, which could cause delays or further payments or compensation. After all, ring-fencing is merely a part of a whole range of measures. As it stands, ring-fencing as proposed appears to be problematic. A possible way of improving it is by insisting on separating out proprietary trading activities and specific other derivatives and securities related activities into separate legal entities. This would be more akin to the Volcker rule and the Liikanen report.<sup>180</sup> This would result in a much smaller and more practicable separation.

Consider the objective of the ring-fence: the purpose of the retail ring-fence is to isolate those banking activities where continuous provision of service is vital to the economy and to a bank's customers in order to ensure, first, that this provision is not threatened as a result of activities which are incidental to it and, second, that such a provision can be maintained in the event of the bank's failure without government solvency support. Reintroducing a Glass-Steagall-type separation would be intrusive. It is arguably no more intrusive than any of the forced mergers that took place during the crisis. The differences are that these mergers happened in the heat of the moment and appeared to be good deal for both sides: one was rescued and the other got a bargain. A further step is needed to make it work. Ring fencing could further to abolish Volker rule, see also Walker Review below.

## **The Walker Review**

The Walker Review took place in the UK after the financial crisis, ordered by the Labor government. It contains some recommendations as regards remuneration. The terms of reference for the review were to examine corporate governance in the UK banking industry and make recommendations, including the effectiveness of risk management at board level, the balance of skills, experience and independence required on the boards of UK banking institutions; the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees; the role of institutional shareholders in engaging effectively with the companies and monitoring the boards; and whether the UK approach is consistent with international practice and how national and international practice can be promulgated. The report makes recommendations in the role and constitution of the board, the board composition and education, the role of shareholders, risk management, and remuneration. The Review is in line with the report on improvements to corporate governance by the Basel Committee<sup>181</sup> but applied to the UK situation.

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<sup>180</sup>

Liikanen et al 100

<sup>181</sup>

Basel Committee on Banking Supervision (n 45)

Remuneration has been discussed in principles 10 and 11 of the Basel Committee<sup>182</sup> and in relation to the discrepancy between remuneration and banks' risk appetite observed by the Senior Supervisors Group.<sup>183</sup> The Walker Review takes a different approach and bases its assessment of remuneration on a report by the Financial Services Authority called the Remuneration Code 2009.<sup>184</sup> The Financial Services Authority later updated the Remuneration Code<sup>185</sup> to reflect the Capital Requirements Directive EU CRD3, the Financial Services Act 2010 and the Walker Review itself. The objectives of the Remuneration Code 2009 are to sustain market confidence and promote financial stability through removing the incentives for risk taking by firms, and to protect consumers.<sup>186</sup> Although the Remuneration Code recognizes that remuneration practices were not the dominant factor in the crisis, it states that it has contributed. There are other elements of culture than are important to protect consumers. Some of these include acting with due care and integrity, creating accountability, promoting competition, and treating customers fairly. The review points out that much of the governance of remuneration is arranged through the Companies Act 2006, s420-422 provide details on directors' pay and s215-217 provide details on severance packages for directors. There is a category of what is called high end employees within financial institutions, perhaps more prominent than in any other industry, who earn more than the median of the board, often have a function of significant influence and who could impact on the risk profile of the bank.<sup>187</sup>

## Transactions with the company

By definition, where a director enters into a transaction with a company, there is a conflict between the director's interest to do well for himself out of the transaction and his duty to the company to ensure that the company gets as much as it can out of the transaction. This rule is so strictly enforced that, even where the conflict of interest or conflict of duty is purely hypothetical, the directors can be forced to disgorge all personal gains arising from it. A

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ibid

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Senior Supervisors Group (n 1)

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Financial Services Authority, 'Reforming Remuneration Practices in Financial Services: Feedback on CP09/1 and Final Rules' (August 2010) <[http://hb.betterregulation.com/external/fs09\\_05.pdf](http://hb.betterregulation.com/external/fs09_05.pdf)>

185

Financial Services Authority, 'Revising the Remuneration Code: Feedback on CP10/19 and the Final Rules' (December 2010) <[http://www.fsa.gov.uk/pubs/policy/ps10\\_20.pdf](http://www.fsa.gov.uk/pubs/policy/ps10_20.pdf)>

186

Financial Services Authority (n 63) 6

187

Sir David Walker (n 4) 109

corporate body can act by agents, and it is the duty of those agents so to act as best to promote the interests of the corporation whose affairs they are conducting.<sup>188</sup>

### **Use of corporate property, opportunity, or information**

Directors must not use for their own profit the company's assets, opportunities, or information. This prohibition is much less flexible than the prohibition against the transactions with the company and attempts to circumvent it using provisions in the articles have met with limited success. In the House of Lords, in upholding what was regarded as a wholly unmeritorious claim by the shareholders, held that what the directors did was so related to the affairs of the company that it can properly be said to have been done in the course of their management and in the utilization of their opportunities and special knowledge as directors; and that what they did resulted in profit to themselves.<sup>189</sup>

### **Remedies for breach of duty**

It is clear that it is a breach of fiduciary duty for a director to wrongfully authorize the transfer of company assets to another company and that his breach lies in the act of signing the transfer forms, not in his failure to make proper enquiries before signing.<sup>190</sup> A director took expert professional advice in relation to a highly technical matter may give him a good answer to any allegation of breach of fiduciary duty.<sup>191</sup> In relation to the taking of professional advice<sup>192</sup> there should be an agreed procedure for directors in furtherance of their duties to take independent professional advice if necessary, at the company's expense. This procedure should be set out in a formal document.<sup>193</sup> It is important for directors to fulfill their mission and see that corporate resources are used efficiently. Directors should prepare themselves for roles beyond the selection of the chief executive officer and other senior management personnel or even the issue of succession planning. Such additional roles may include: the determination of board policies, and corporate mission and direction; the establishment of performance standards, both ethical and commercial, by which the

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*Aberdeen Ry v. Blaikie*(1854) 1 Macq HL 461

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*Regal (Hastings) Ltd v Gulliver* [1942] All ER 378

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*Bishopsgate Investment Management Ltd v Maxwell* (1994) 1 All ER 261

191

*Norman v Theodore Goddard* (1992) BCC 14

192

Cadbury Code of Best Practice

193

Susan Barber, *Company Law Textbook*, Fourth Edition (Old Bailey Press, 2004) pp236-237.



management will be judged and their explicit communication to management in unambiguous terms; and the reviewing of top management's performance in following the overall strategy and standards set by the board.<sup>194</sup>

Directors owe duties to the company and not to any individual shareholder or outside body.<sup>195</sup> The proponents of the stakeholder approach regard the company as the collective interests of shareholders, creditors and employees. A director must conduct the business affairs of a company for the benefit of the company as a whole and not for some other collateral purpose.<sup>196</sup> The test is subjective; it may be passed even if the court considers the actions to have been unreasonable, providing a director honestly believed he was acting in the company's best interests. Although a director may believe that in entering a transaction he is acting in the best interests of the company as a whole, he will be held to be in breach of his fiduciary duty if the purpose of the transaction was outside or in abuse of the director's allocated powers; even though the transaction may not have been outside the contractual capacity of the company.<sup>197</sup> A leading case on the application of the proper purpose duty.<sup>198</sup> The approach of construing the proper purpose rule to be the dominant element in the determination of whether a corporate act was in the best interests of a company is generally followed by the English courts. The conflict of interest rule is closely related, as rule of equity, to the fiduciary duties owed by a director of a company. A breach of the conflict of interest rule will result in a breach of fiduciary duty<sup>199</sup>, but not always.<sup>200</sup> The rule may be stated as rule which prohibits a director from using a corporate opportunity for his own personal use or benefit.<sup>201</sup> This principle of equity, equally applicable to a trustee-beneficiary

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Dan A. Bavly, *Corporate Governance and Accountability* (Quorum Books, Westport, Connecticut, London, 1999) pp92-93.

195

*Percival v Wright* (1902) 2 Ch 421.

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*Re Smith Fawcett Ltd* (1942) Ch 304, *Re W & M Roith Ltd* (1967) 1 WLR 432, *Regentcrest plc v Cohen* (2001) BCC 494, *Extrasure Travel Insurance Ltd v Scattergood* (2003) 1 BCLC 598.

197

*Hogg Cramphorn* (1967) Ch 254, *Bishopsgate Investment Management Ltd* (1993) BCC140.

198

*Howard Smith Ltd v Ampol Petroleum Ltd* (1974) AC 821 applied in *Mutual Life Insurance Co v The Rank Organisation Ltd* (1985) BCLC 11.

199

*JJ Harrison Properties Ltd v Harrison* (2002) 1 BCLC 162

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*Regal (Hastings) Ltd v Gulliver* (1942) (1967) 2 AC 134

201

relationship, is referred to as the fair dealing rule. A transaction which involves a conflict of interest, unless exempted by the company's articles will, unlike a breach of a fiduciary duty, be set aside without enquiry as to whether any harm was inflicted on the company.<sup>202</sup> The conflict of interest rule is strict in the sense that it fails to distinguish between, directors who have set out to exploit a corporate opportunity and directors who have profited from a corporate opportunity in a situation where the company was, at the time of the opportunity, unable or unwilling to act upon the opportunity. In Canada the approach is to impose liability in circumstances which suggest that the director in question acted in bad faith.<sup>203</sup>

The standard of care expected from executive directors will be of a higher standard than for non-executive director however, where non-executive directors are entrusted with business matters in which they have a personal expertise, they too must exhibit a reasonable standard of care appropriate to their level of expertise.<sup>204</sup> The judicial interpretation of the nature of the duty of care expected of a director was based upon the judgment of a decided case.<sup>205</sup> Although elements of the characteristics put forward by *Romer J* are still to be found, the said characteristics have been subject to a significant shift towards a stricter approach to the construction of the duty.<sup>206</sup> The characteristics may be said to comprise the standard whereby, a director need not exhibit in the performance of his duties any greater degree of skill than could reasonably be expected from a person occupying a similar position, that person having the general knowledge, skill and experience that may be reasonably be expected of the holder of the position in question. However, the knowledge, skill and experience of the particular director accused of breaching the duty should be considered in determining whether there has been a breach. The test is comparable to the one used to determine wrongful trading.<sup>207</sup> The duty of care is owed by the director once the company is insolvent or nearing insolvency.

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Bhullar v Bhullar (2003) 2 BCLC 241

202

Aberdeen Railway Co v Blaikie Bros (1854) 1 Macq 461, Boardman v Phipps (1967) AC 46, CMS Dolphin v Simonet (2002) BCC 600, Quarter Master v Pyke (2005) 1 BCLC 245

203

Peso Silver Mines Ltd v Cropper (1966) 58 DLR (2d)1

204

Dorchester Finance Co Ltd v Stebbing (1989) BCLC 498

205

Romer J in Re City Equitable Fire Insurance Co Ltd (1925) Ch 407

206

Lister v Romford Ice & Cold Storage Ltd (1957) A.C. 555, Norman v Theodore Goddard (1991) BCLC 1028 and Re D'Jan of London Ltd (1993) BCC 646

207

s.214 IA 1986

Directors are obliged to follow the necessary procedures that are set to assure accountability and disclosure of the manner in which management performs its stewardship.<sup>208</sup> The buck stops with the directors who make up the board. It makes no difference whether they are executive or non-executive, independent, alternates, or merely acting directors. They are all accountable for the actions of the board and are ultimately responsible for the results of the company they direct.<sup>209</sup>

## **Link with financial regulations**

The domain of an auditor clearly covers the authenticity verification of transactions. It is however, when the entire organization collapses, the auditor giving a statement mentioning that we have checked the books produced by the company and not verified it. It is important that the regulators and other investigating agencies must look the said issue as a system failure rather than only a monetary fraud. Under the corporate system, the position of the owner has been reduced to that of having a set of legal and factual interests in the enterprise while the management group, which has control, is in a position of having legal and factual powers over it.<sup>210</sup>

From a public policy perspective, corporate governance is about nurturing enterprises while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders.<sup>211</sup> The negative aspects of limited liability have long been recognized to the extent that common law and statutory provisions have evolved to curb the exploitation of the limited liability company. The protection provided by such measures is nonetheless invoked as a rarity. The fraudulent trading provision (s.213 IA 1986) has been used in only a handful of cases because of the difficulty of establishing a director's dishonest intent.<sup>212</sup> The prohibition against phoenix companies has delivered so few cases as to suggest the problem does not exist, when in practice it clearly does. S. 213 IA 1986 is linked to director disqualification and disqualification may directly or indirectly lead to compensation orders, see also

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208

Com. Print, Committee on Banking, Housing and Urban Affairs, 94<sup>th</sup> Congress, 2<sup>nd</sup> Session 1976

209

Peter Wallace & John Zinkin, *Corporate Governance* (John Wiley & Sons (Asia) Pte Ltd, 2005) pp275-276.

210

Kevin Keasey, Steve Thompson and Mike Wright, *Corporate Governance, Volume III*, (Edward Elgar Publishing Limited, 1999) p192.

211

Magdi R. Iskander & Nadereh Chamlou, *Corporate Governance: A Framework for Implementation* (The World Bank Group, Washington, D.C., 2000) p3.

212

s.214 IA 1986

Schedule 6 to the Insolvency Act 1986, ss 15A – 15C and s 13 of the Financial Services (Banking Reform) Act 2013 Act.

S 13(1) In schedule 6 to the Insolvency Act 1986 (Categories of preferential debts) after paragraph 15A insert—“Category 7: Deposits covered by Financial Services Compensation Scheme

15B So much of any amount owed at the relevant date by the debtor in respect of an eligible deposit as does not exceed the compensation that would be payable in respect of the deposit under the Financial Services Compensation Scheme to the person or persons to whom the amount is owed.

Interpretation for Category 7

15C (1)In paragraph 15B “eligible deposit” means a deposit in respect of which the person, or any of the persons, to whom it is owed would be eligible for compensation under the Financial Services Compensation Scheme. (2)For this purpose a “deposit” means rights of the kind described in— (a)paragraph 22 of Schedule 2 to the Financial Services and Markets Act 2000 (deposits), or (b)section 1(2)(b) of the Dormant Bank and Building Society Accounts Act 2008 (balances transferred under that Act to authorised reclaim fund).” (2)In section 386 of the Insolvency Act 1986 (categories of preferential debt), in subsection (1), after “production” insert “ ; deposits covered by Financial Services Compensation Scheme ”. (3)In Part 1 of Schedule 3 to the Bankruptcy (Scotland) Act 1985 (list of preferred debts), after paragraph 6A insert—

“Deposits covered by Financial Services Compensation Scheme

6B So much of any amount owed at the relevant date by the debtor in respect of an eligible deposit as does not exceed the compensation that would be payable in respect of the deposit under the Financial Services Compensation Scheme to the person or persons to whom the amount is owed.”

(4)In Part 2 of Schedule 3 to the Bankruptcy (Scotland) Act 1985 (interpretation of Part 1), after paragraph 9 insert—

“Meaning of eligible deposit

9A(1)In paragraph 6B “eligible deposit” means a deposit in respect of which the person, or any of the persons, to whom it is owed would be eligible for compensation under the Financial Services Compensation Scheme. (2)For this purpose a “deposit” means rights of the kind described in paragraph 22 of Schedule 2 to the Financial Services and Markets Act 2000 (deposits).”

Delinquent directors have been subject to disqualification but the number of disqualifications, compared to the number of company liquidations, suggests that the disqualification provisions are merely skimming the surface in removing unfit directors.<sup>213</sup>

The statutory and common law attempts to curb the exploitation of the limited liability have proved ineffective. In practice the cases tend to be brought under s.214 because it is easier to prove. The outcome tends to be much the same in that the directors concerned become personally liable. Banking supervision asks public agencies to second-guess the decisions of executives who earn millions in bonuses and business strategies that yield billions in profit. Perhaps there was once a golden age when the authority and wisdom of central bankers were so great that such regulation was possible and effective, although the recurrence of bank crises in the United States from 1865 to 1929 suggests otherwise. The financial services industry is the most powerful political lobby in the country and public trust in and respect for regulation are low. But in financial services, the demand is for more regulation. The government should protect small depositors and ensure that the payment system for households and businesses continues to function. There should be the same powers to take control of essential services in the event of corporate failure that exist for other public utilities. The deposit protection scheme should have preferential creditor status to restrict the use of retail deposits as collateral for speculative activities.<sup>214</sup> In addition, s 36 of the Financial Services (Banking Reform) Act 2013 Act also designed to deal with bank failure specifically (in light of the perceived culpability of Fred Goodwin).

S 36 Offence relating to a decision causing a financial institution to fail

(1) A person (“S”) commits an offence if— (a) at a time when S is a senior manager in relation to a financial institution (“F”), S- (i) takes, or agrees to the taking of, a decision by or on behalf of F as to the way in which the business of a group institution is to be carried on, or (ii) fails to take steps that S could take to prevent such a decision being taken, (b) at the time of the decision, S is aware of a risk that the implementation of the decision may cause the failure of the group institution, (c) in all the circumstances, S's conduct in relation to the taking of the decision falls far below what could reasonably be expected of a person in S's position, and (d) the implementation of the decision causes the failure of the group institution.

(2) A “group institution”, in relation to a financial institution (“F”), means F or any other financial institution that is a member of F's group for the purpose of FSMA 2000 (see section 421 of that Act).

(3) Subsections (1) and (2) are to be read with the interpretative provisions in section 37.

(4) A person guilty of an offence under this section is liable—

(a) on summary conviction— (i) in England and Wales, to imprisonment for a term not exceeding 12 months (or 6 months, if the offence was committed before the commencement of section 154(1) of the Criminal Justice Act 2003) or a fine, or both; (ii) in Scotland, to imprisonment for a term not exceeding 12 months or a fine not exceeding the statutory

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Company Directors Disqualification Act (s.6)

214

Kay, J., ‘More Regulation Will Not Prevent Next Crisis’, Financial times, 26 March 2008, available in the website: <http://www.johnkay.com/2008/03/26/more-regulation-will-not-prevent-next-crisis>.

maximum, or both; (iii) in Northern Ireland, to imprisonment for a term not exceeding 6 months or a fine not exceeding the statutory maximum, or both; (b) on conviction on indictment, to imprisonment for a term not exceeding 7 years or a fine, or both.

## **Governance of Delinquent Directors following Insolvency**

It is the duty of the court to make a disqualification order against any person in a case where: (a) that person is or has been a director of a company which has at any time become insolvent; and (b) that person's conduct as a director of the company makes the person unfit to be concerned in the management of a company.<sup>215</sup> The minimum period of disqualification, following a contravention of section 6(1), is two years.<sup>216</sup> The maximum period for disqualification under section 6 is 15 years.

Focusing solely on dilution and the cost of stock options begs the question on a number of issues, notably: what types of companies may benefit from option-based compensation, what types of employees should receive option-based compensation, and whether or not the benefits of option-based compensation outweigh the costs. Shareholder concerns suggest that option-based compensation will continue to be a focal point for controversy.<sup>217</sup> The compensation of managers in listed companies can be designed to ensure that they must regard the creation of shareholder value as the primary objective in the short term and in the long term. Option schemes could include exercise dates postdating the departure of the manager from the company.<sup>218</sup> The introduction of agency theory suggested that compensation should probably be contingent on more than one performance measure and predicted that the relative importance of alternate performance measures should be a function of their precision and sensitivity to the manager's performance.<sup>219</sup> Regardless of the absolute level of the CEO's compensation over some time period, the board, shareholders, and the world at large will look at this compensation in terms of the market value of the company's shares created during the relevant time period, as measured by the increase of the market capitalization of the firm. Only the shareholders can answer the question as to the fairness of

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<sup>215</sup>

Section 6(1) of the Company Directors Disqualification Act 1986

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Section 6(4) of the Company Directors Disqualification Act 1986

<sup>217</sup>

Donald H. Chew Jr. & Stuart L. Gillan, *Corporate Governance at the Crossroads* (McGrawHill, 2005) p245.

<sup>218</sup>

Peter K. Cornelius & Bruce Kogut, *Corporate Governance and Capital Flows in a Global Economy* (Oxford University Press, 2003) p440.

<sup>219</sup>

Kevin Keasey, Steve Thompson and Mike Wright, *Corporate Governance, Volume III*, (Edward Elgar Publishing Limited, 1999) p192.

the CEO's compensation – and then only in the context of the gains that accrued to the shareholders during the relevant time period.<sup>220</sup>

Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders. In some jurisdictions there is a standard of reference which is the behavior that a reasonably prudent person would exercise in similar circumstances. The duty of loyalty is of central importance, since it underpins effective implementation of other principles in this document relating to, for example, the equitable treatment of shareholders, monitoring of related party transactions and the establishment of remuneration policy for key executives and board members. It is a key principle for board members who are working within the structure of a group of companies: even though a company might be controlled by another enterprise, the duty of loyalty for a board member relates to the company and all its shareholders and not to the controlling company of the group.<sup>221</sup>

### **Disqualification for fraudulent/wrongful trading**

A court may find a person liable under sections 213 or 214 respectively for fraudulent trading or wrongful trading under the Insolvency Act 1986. Further, the court under s 10 of the CDDA 1986 may of its own volition make a disqualification order against that person. The maximum period for an order under s 10 is 15 years, e.g. *Re Brian D Pierson (Contractors) Ltd*<sup>222</sup>, see also s 36 of the Financial Services (Banking Reform) Act 2013 – offence of causing a bank to fail.

### **Difference between legal systems**

Limited liability has been the vehicle for economic expansion and from the time of its introduction the corporate form has encouraged capital to be aggregated for investment purposes. In the nineteenth century, loan funds for small to medium size entrepreneurs were not readily available and thus the aggregation of capital through the medium of the company was a means to enhance the value and potential of a small business. As part of the twentieth century's credit boom, the availability of business loans has, in private companies, deflated the need for the aggregation of capital. In the context of a private company, a limited liability status may not necessarily be viewed as an advantage in the funding of the enterprise. In private companies comprised of very few members and where the majority of the memberships are directors of the company, the advantage of limited liability may be artificial because large creditors of the enterprise and in particular the banks are likely to

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<sup>220</sup>

John L. Colley, JR., *Corporate Governance*, (Mcgraw-Hill, 2003) p130.

<sup>221</sup>

Organisation for Economic Co-operation and Development, 'OECD Principles of Corporate Governance', 2004, Preamble, pg.59, available in the website: <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

<sup>222</sup>

(1999) BCC 26. Stephen Griffin, *Company Law* (Pearson Education, 2000) p314.

demand personal guarantees of the members/directors to secure the repayment of debts and to secure this against their personal assets. To this end, should the company become insolvent; the company's human constituents will gain little from having traded the enterprise as a limited liability company.

### **United States Corporate Governance**

Individual rules for corporations are based upon the corporate charter and, less authoritatively, the corporate bylaws. In the United States, shareholders cannot initiate changes in the corporate charter although they can initiate changes to the corporate bylaws. Corporate governance seems to have been used to denote the structure and functioning of the corporate policy.<sup>223</sup> Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization. Of importance is how directors and management develop a model of governance that aligns the values of the corporate participants and evaluate this model periodically for its effectiveness.

### **Commonly accepted principles of corporate governance**

Rights and equitable treatment of shareholders: organizations should respect the rights of shareholders and help shareholders to exercise those rights. They can help shareholders exercise their rights by effectively communicating information that is understandable and accessible and encouraging shareholders to participate in general meetings. Interests of other stakeholders: organizations should recognize that they have legal and other obligations to all legitimate stakeholders.

Disclosure and transparency: organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information. Nevertheless, corporate governance, despite some feeble attempts from various quarters, remains an ambiguous and often misunderstood phrase. It was confined only to corporate management. It must include a fair, efficient and transparent administration and strive to meet certain well defined, written objectives. Corporate governance must go well beyond law.<sup>224</sup> Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection.

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223

Eells, R., *The Meaning of Modern Business: An Introduction to the Philosophy of Large Corporate Enterprise*, Columbia University Press, New York, 1960, p 106

224

The quantity, quality and frequency of financial and managerial disclosure, the degree and extent to which the board of directors exercise their trustee responsibilities, and the commitment to run a transparent organization- these should be constantly evolving due to interplay of many factors and the roles played by the more progressive elements within the corporate sector.



Corporate and organizational bylaws regulate only the organization to which they apply and are concerned with the operation of the organization, setting out the form, manner or procedure in which a company or organization should be run. In parliamentary procedure, the bylaws are the supreme governing document of an organization, superseded only by the charter of an [incorporated society](#).<sup>225</sup> The bylaws contain the most fundamental principles and rules regarding the nature of the organization. It was common practice for organizations to have two separate governing documents, a constitution and bylaws, but this has fallen out of favor because of the ease of use, increased clarity, and reduced chance of conflict inherent in a single, unified document. Unless otherwise provided by law, the organization does not exist until bylaws have been adopted.<sup>226</sup> The board of directors is selected by and responsible to the shareholders, but the bylaws of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board; normally, individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubberstamp the nominees of the sitting board.

Corporate governance principles and codes have been developed in different countries and issued from stock exchanges, corporations, institutional investors, or associations of directors and managers with the support of governments and international organizations. In the United States, companies are regulated by the state in which they incorporate though they are regulated by the federal government and, if they are public, by their stock exchange. The guidelines issued by associations of directors, corporate managers and individual companies tend to be wholly voluntary. The GM Board Guidelines reflect the company's efforts to improve its own governance capacity. Such documents may have a wider multiplying effect prompting other companies to adopt similar documents and standards of best practice.<sup>227</sup>

### **The historical development of corporate powers**

The statutory regulation of the division of corporate powers was ordained in favor of the collective will of a company's membership, i.e., the company in general meeting. A company's board of directors was not considered to be an organ of the company but was appointed to carry out the will of the general meeting. Conflicts between the board and general meeting were ordinarily resolved to the latter's advantage. The ability of the general meeting to supervise and if necessary determine corporate policy persisted throughout the nineteenth century. The growth and expansion of the corporate form over time inevitably resulted in the general meeting's decline in matters involving the dictating of corporate policies. Many shareholders invested in companies for potential profit and not for the right

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<sup>225</sup>

Robert's Rules of Order

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In some jurisdictions these are known as "articles of association" and in other as the company's "statutes". [http://en.wikipedia.org/wiki/Bylaw#Corporate\\_bylaws](http://en.wikipedia.org/wiki/Bylaw#Corporate_bylaws)

<sup>227</sup>

<http://www.answers.com/topic/corporate-governance>

to participate in management decisions. In expanding companies, the partnership principles on which the corporate form had been founded no longer ruled supreme. Membership interest, attendance, and participation at general meetings all declined. This decline was prevalent in larger companies where commercial reality dictates that the administration of corporate policy demands a consolidation of corporate powers into a centralized body, meaning the board of directors. The convergence when existing governance institutions are flexible enough to respond to the demands of changed circumstances without altering the institutions' formal characteristics; formal convergence, when an effective response requires legislative action to alter the basic structure of existing governance institutions; and contractual convergence, where the response takes the form of contract because existing governance institutions lack the flexibility to respond without formal change, and political barriers restrict the capacity for formal institutional change.<sup>228</sup>

### **The business judgment rule**

The business judgment rule is a presumption that directors making a business decision, not involving self-interest, acted in good faith and with due care.<sup>229</sup> The business judgment rule, prevents a substantive review of the merits of a business decision made by directors acting, without self-interest and in good faith and with due care. The business judgment rule is based on the proposition that directors, and not the courts, are charged with the management of the business of the corporation. In effect it takes away the objective proper purpose test found in the UK. Managers, because of their experience and access to information, are better able than shareholders or the courts to make business decisions. In the US, it is acknowledged that undue exposure to liability would deter persons from serving as directors. The rule has never been absolute. Its exceptions are as follows: (1) The business judgment rule does not apply if the plaintiff can show self-dealing. Thus, where a director has a conflict of interest in a transaction and where the transaction is not approved by a majority of disinterested directors, the directors are not entitled to the protection of the business judgment rule. The approval of a transaction by a majority of independent, disinterested directors enhances the presumption that the business judgment rule applies; (2) The presumption only applies if reasonable diligence has been exercised, so the rule will not apply to instances whereby a director has failed to take adequate advice or has left the company's affairs in the hands of another without providing adequate supervision. Although a conscious decision not to take action may be protected by the business judgment rule, the

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228

Jeffrey N. Gordon, *Convergence and persistence in Corporate Governance?* (Cambridge University Press, 2004) pp157-158.

229

The Delaware Supreme Court stated this in *Aronson v Lewis*: 1984.

rule does not apply where directors have failed to give thought and act to a situation and (3) The business judgment rule will not provide a director who did not act in good faith or whose decision constitutes a gross negligence.

### **Corporate Power**

The wording of article 80 permitted conflicts appertaining to the division of corporate powers to be resolved by the general meeting, in so far as it provided that the company's directors were to manage the company but subject to contrary regulations passed by the company in general meeting.<sup>230</sup> In Marshall's case the court permitted a majority shareholder to commence litigation in the name of the company despite the refusal of a majority of the board to sanction the litigation. The relevant article of the company, which determined the division of powers between the board and general meeting, was drafted in a similar vein to 1948 Table A, art 80. However, table A, art 80 is an old article, we may also see s 177 Companies Act 2006. The director has the duty to declare interest to the board of director – the effect is the same as the old 1985 regime.

### **Conspiring in or tolerating legal violations**

A board that conspires to break the law is likely to get into serious trouble. The results of such situations are obvious, as all involved parties suffer the consequences. Directors must have the strength of character to respond to any pressures that hint of legal wrongdoings. They should act to protect themselves and the interests of the shareholders from those with criminal intent. Autonomy could be given to the boards of listed companies to find their managers from the market. This could include recommendations from the majority shareholder who will continue to be advised by the Party Organization Department, but the board of a listed company will be given the responsibility to consider these candidates against the best available candidates in the market. With the development of globalization, companies in civil law jurisdictions have sought to raise capital from the countries such as in the US, UK and EU.

### **The development of corporate governance codes**

After the publication of Berle and Means' work in 1932, their work detailed the separation of ownership from management which resulted in lack of power in the hands of the shareholders to keep controlling the management of large public corporations who are supposed to work in their interests. Alongside the division of control and ownership, another concern of equal importance results from the dispersion and diffusion of the ownership, which reduces their abilities to run the corporation collectively, with the option of being able to sell their shares which can be taken by shareholders who are not satisfied with the performance of the firm.

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230

The decision of Neville J in *Marshall's Valve Gear Co Ltd v Manning, Wardle & Co Ltd* (1909) 1 Ch 267 was supportive of the view that the general meeting had authority over the board in a situation of conflict.

In the Cadbury Report (1992), institutional shareholders were encouraged to take a more involved and active role in monitoring the companies, especially with regard to applying their votes at the annual general meeting.<sup>231</sup> The London International Stock Exchange (LISE) accepted the Cadbury report recommendations as the best practice. In November 1995, the Cadbury Committee and the Greenbury Committee requested the establishment of another committee to review the implementation of their committees' recommendations. The committee was sponsored by The Confederation of British Industry, The Consultative Committee of Accountancy Bodies, The London Stock Exchange, The National Association of Pension Funds, and the Association of British Insurers (Cadbury, 1992). The Hampel Committee started its deliberations in 1995, which coincided with Greenbury recommendations (1995) to promote high standards of corporate governance. Following the Enron and WorldCom Scandals the Smith Committee had been established. The Government responded to the corporate failure in the US and requested the Financial Reporting Council to assess the preparedness in the country in avoiding such failure. Higgs and Smith reports of 2003 examined the role and effectiveness of non-executive directors and the role of audit committees, and those reports led to an updating of the Combined Code. The report supports all the main recommendations in the Combined Code such as separation of the positions between the chairman of the board and the chief executive. Sound corporate governance aims to establish principles and practices for all listed companies to comply with. Firm's governance quality is linked to the degree of variation in extent and form of compliance with the Code which is supposed to be reflected on its performance as well.<sup>232</sup>

### **UK Corporate Governance Code**

The FRC has launched a consultation on its proposals to reform the UK's Corporate Governance Code (the Code). The Code has been revised regularly to ensure it reflects changing governance concerns and practices and economic circumstances. The latest proposals take into account those lessons of the financial crisis that are relevant to all companies. The principal lesson of the financial crisis is that those on boards must think deeply about their individual and collective roles and responsibilities. The chairman has a vital role to play in ensuring that the executives have appropriate freedom to manage the business and accept the importance of opening themselves to challenge and earning the trust of the whole board. For their part, the non-executives must have the skills, experience and courage to provide such challenge. The Code is made up of strong principles that require careful thought and application to the circumstances of each company. To ensure the board is well balanced and challenging, new principles are put forward on the leadership of the chairman, the roles, skills and independence of the non-executive directors and their level of time commitment. To enhance the board's performance and awareness of its strengths and

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<sup>231</sup>

The Cadbury Code (1992) encouraged the accounting profession to seek options in which the statutory audit might become more effective and objective (Collier and Gregory, 1996).

<sup>232</sup>

Firms complying with the Code indicate good governance and because less agency costs exist, it is likely in theory to have better performance and increased firm's value.

weaknesses, board evaluation reviews should be facilitated every three years and the chairman should hold regular development reviews with each director.

The UK Corporate Governance Code (formerly known as the Combined Code) sets out standards of good practice for listed companies on board composition and development, remuneration, shareholder relations, accountability and audit.<sup>233</sup> The UK Corporate Governance Code ("the Code") is a set of principles of good corporate governance aimed at companies listed on the London Stock Exchange. It is overseen by the Financial Reporting Council and its importance derives from the FCA's Listing Rules which are given statutory authority under the Financial Services and Markets Act 2000<sup>234</sup> and require that public listed companies disclose how they have complied with the code, and explain where they have not applied the code - in what the code refers to as comply or explain.<sup>235</sup>

The Code is a consolidation and refinement of a number of different reports and codes concerning opinions on good corporate governance. The first step on the road to the initial iteration of the code was the publication of the Cadbury Report in 1992. Produced by a committee chaired by Sir Adrian Cadbury, the Report was a response to major corporate scandals associated with governance failures in the UK. The committee was formed in 1991 after Polly Peck, a UK company, became insolvent after years of falsifying financial reports. Hence the final report covered financial, auditing and corporate governance matters, and made the following three basic recommendations: the CEO and Chairman of companies should be separated; boards should have at least three non-executive directors, two of whom should have no financial or personal ties to executives; and each board should have an audit committee composed of non-executive directors. These recommendations were highly controversial, although they did no more than reflect the contemporary best practice and urged that these practices be spread across listed companies. It was emphasized by Cadbury that there was no such thing as one size fits all.<sup>236</sup> In 1994, the principles were appended to the Listing Rules of the London Stock Exchange, and it was stipulated that companies need not comply with the principles, but had to explain to the stock market why not if they did not. Before long, a committee chaired by chairman of [Marks & Spencer](#) Sir Richard Greenbury was set up as a study group on executive compensation.

Greenbury recommended that progress be reviewed every three years and so in 1998 Sir Ronald Hampel, who was chairman and managing director of ICI plc, chaired a third

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<sup>233</sup>

<https://www.icaew.com/en/library/subject-gateways/corporate-governance/codes-and-reports/uk-corporate-governance-code>

<sup>234</sup>

Financial Services and Markets Act 2000s [2\(4\)\(a\)](#) and generally [Part VI](#)

<sup>235</sup>

Listing Rule [9.8.6\(6\)](#)

<sup>236</sup>

V Finch, 'Board Performance and Cadbury on Corporate Governance' [1992] *Journal of Business Law* 581

committee. The ensuing Hampel Report suggested that all the Cadbury and Greenbury principles be consolidated into a "Combined Code". It added that, the Chairman of the board should be seen as the leader of the non-executive directors; institutional investors should consider voting the shares they held at meetings, though rejected compulsory voting; and all kinds of remuneration including pensions should be disclosed. It rejected the idea that had been touted that the UK should follow the German two-tier board structure, or reforms in the EU Draft Fifth Directive on Company Law.<sup>237</sup> A mini-report was produced the following year by the Turnbull Committee which recommended directors be responsible for internal financial and auditing controls. A number of other reports were issued through the next decade, including the Higgs review, from Derek Higgs focusing on what non-executive directors should do, and responding to the problems thrown up by the collapse of Enron in the US. Paul Myners completed two major reviews of the role of institutional investors for the Treasury, whose principles were found in the Combined Code. Shortly following the collapse of [Northern Rock](#) and the Financial Crisis, the Walker Review produced a report focused on the banking industry, but with recommendations for all companies.<sup>238</sup> In 2010, a new Stewardship Code was issued by the Financial Reporting Council, along with a new version of the UK Corporate Governance Code, hence separating the issues from one another. In 2012, the Combined Code was replaced by a new updated Corporate Governance Code. Revisions to the earlier code included FTSE 350 companies having to put the external audit contract out to tender at least every ten years. The updated Code (and a slightly modified Stewardship Code) was effective from 1 October 2012.<sup>239</sup>

## Section A: Leadership

Every company should be headed by an effective board which is collectively responsible for the long-term success of the company. There should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. No one individual should have unfettered powers of decision. The chairman is responsible for leadership of the board and ensuring its effectiveness on all aspects of its role.

## Section B: Effectiveness

The board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. There should be a formal, rigorous and transparent

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<sup>237</sup>

A Dignam, 'A Principled Approach to Self-regulation? The Report of the Hampel Committee on Corporate Governance' [1998] Company Lawyer 140

<sup>238</sup>

David Walker, A review of corporate governance in UK banks and other financial industry entities (2009)

<sup>239</sup>

Jill Solomon, Corporate Governance and Accountability, fourth edition, Wiley, United Kingdom, 2013, pg. 65.

procedure for the appointment of new directors to the board. All directors should be able to allocate sufficient time to the company to discharge their responsibilities effectively. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge. The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.<sup>240</sup>

#### Section C: Accountability

The board should present a balanced and understandable assessment of the company's position and prospects. The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives.

#### Section D: Remuneration

Levels of remuneration should be sufficient to attract, retain and motivate directors of the quality required to run the company successfully, but a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

#### Section E: Relations with Shareholders

There should be a dialogue with shareholders based on the mutual understanding of objectives. The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should use the AGM to communicate with investors and to encourage their participation.

### **Compliance**

In its 2007 response to a Financial Reporting Council consultation paper in July 2007 Pensions & Investment Research Consultants Ltd reported that only 33% of listed companies were fully compliant with all of the Codes provisions.<sup>241</sup> Spread over all the rules, this is not necessarily a poor response, and indications are that compliance has been climbing. PIRC maintains that poor compliance correlates to poor business performance, and at any rate a key provision such as separating the CEO from the Chair had an 88.4% compliance rate. The question thrown up by the Code's approach is the tension between wanting to maintain flexibility and achieve consistency. The tension is between an aversion to one size fits all solutions, which may not be right for everyone, and practices which are in general agreement to be tried, tested and successful. If companies find that non-compliance works for them,

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<sup>240</sup>

<sup>241</sup> The board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.

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and shareholders agree, they will not be punished by an exodus of investors. So, the chief method for accountability is meant to be through the market, rather than through law. An additional reason for a Code, was the concern of the Cadbury Report, that companies faced with minimum standards in law would comply with the letter and not the spirit of the rules.<sup>242</sup> Investor protection is a bedrock principle of capital markets.

### **Changing the culture of financial regulation**

The 2007-09 Global Financial Crisis has been described as the greatest crisis in the history of financial capitalism.<sup>243</sup> The failure of the global financial system was triggered by the great American real estate bubble, it developed into a global liquidity squeeze that left financial markets at the brink of collapse. The culture of banking prevalent at the time both caused and exacerbated the crisis. The business strategies were risky, focusing on short-term gains, at the expense of financial security. It is purported that to mitigate the risks of any future global financial crisis a fundamental change in the culture of banking is needed.

It was in many cases, risk monitoring and management practices within financial institutions that dramatically failed.<sup>244</sup> Whilst prudential regulation is important, the thesis has shown that it is insufficient to change the culture within the financial system; a multifaceted approach is needed. Whilst the new regulatory powers that have been adopted are to be welcomed, formal financial regulation has limitations when addressing the culture within an institution. The limitations can be addressed by improving Corporate Governance structures. There were many cases where internal risk management was ineffective and where senior management failed to adequately identify and constrain excessive risk taking. A greater reliance on formal corporate governance structures would improve this by altering the general culture imposed within an institution. The use of fiduciary obligations as a means to hold directors to account has been largely ignored during the financial crisis, with the focus being clearly towards holding the regulator accountable, a decision that saw the abolition of the Financial Services Authority in 2012. The thesis has shown that a more rigorous application of the objective standard of care under the duty of skill, care and diligence has the capacity to change the decision-making processes of a director for the better.

The objective standard has forced real change in the mind-sets of non-executive directors ensuring that they consider their role as gatekeeper much more seriously. The provision has not gone so far as to state that non-executive directors need be perfect in their decision-making processes, following the crisis, s. 174 has driven a clear cultural shift that has departed away from classic cases such as *Grimwade v Mutual Society* whereby it was noted that directors are not bound to be wiser than those who appointed them. This shift adopted

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<sup>242</sup>

para 1.10 of the Cadbury Report

<sup>243</sup>

Lord Turner, The Turner Review: A regulatory response to the global banking crisis (March 2009) Intro.

<sup>244</sup>

The de Larosi re Group (n 16) para 122.



within a multi-faceted approach is the key to ensuring a change in cultural expectations and norms within the financial crisis. It has been argued that with minor amendments to the provisions of s.172, the imposition of an objective standard of care or alternatively a wider interpretation of relevant factors by the judiciary, s.172 could have a real and positive curbing effect on rogue directors, who do not act to promote the success of the company for the benefit of its members as a whole. Ensuring as much has the capacity to play a vital role within the culture of banking post Global Financial Crisis. The chasing of high, short term profits during the financial crisis, led to generous bonus payments to directors and employees without adequate regard to the longer-term risks they imposed on financial institutions.<sup>245</sup> Whilst remuneration structures need to attract and motivate individuals having characteristics necessary for success in the industry,<sup>246</sup> it is argued that some of the remuneration structures allowed directors to take unnecessary risks.

The thesis around the need for corporate governance mechanisms to play a full part in the legal and regulatory response to the global financial crisis, as part of a cohesive package of measures necessary to effect cultural change within banking has been tested in the context of the collapse of the financial institutions. This study has highlighted how greater emphasis on existing Corporate Governance measures such as s.172, s.174 and remuneration, could have been effective in changing the decision-making processes and prevailing culture within the financial institution is this culture shift which reform to the prudential regulatory environment alone is unlikely to achieve. As has been shown the duties are owed to the company as a whole and as such it is the company who is the proper plaintiff in any action. If the company refuses to bring an action against senior management then the system would have to rely on shareholder activism, through minority shareholder provisions. Whilst there have been some examples of shareholder activism since the crisis, for example the Shareholder Spring of 2012, it remains to be seen whether the appetite for activism will continue when the global financial crisis disappears into distant memory. It is argued that there may be a stronger appetite than first thought following the recent case of R.(on the application of SRM Global Master Fund LP) v Treasury Commissioners. The case concerned a conglomerate of shareholders of Northern Rock who in 2009 for judicial review against the government.<sup>247</sup> In their claim they purported that the legislation relating to the assessment of compensation payable to them as former shareholders of Northern Rock plc following its nationalization in February 2008 was unfair and incompatible with their rights under the European Convention on Human Rights 1950 Protocol 1 Art.1. The shareholders

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245

Financial Stability Forum, 'FSF Principles for Sound Compensation Practices' (April 2009) Now the Financial Stability Board.

246

Walker Review, A review of corporate governance in UK banks and other financial industry entities: Final recommendations (26 November 2009) Section D.

247

R. (on the application of SRM Global Master Fund LP) v Treasury Commissioners [2009] EWHC 227 (Admin).

case was rejected and subsequently pursued to the Court of Appeal, where the case failed on appeal.<sup>248</sup>

## **Conclusion**

This chapter provides an overview of corporate governance. Corporate governance gives attention to power struggle issues between the directors, management, and shareholders. Governance involves the alignment of interests among the stakeholders. The discussion begins with the meaning and implications of corporate governance. We define corporate governance as the collection of control mechanisms that an organization adopts to prevent or dissuade potentially self-interested managers from engaging in activities detrimental to the welfare of shareholders and stakeholders. In the duties of directors and the care and skill of the directors. The level of care and skill a director must demonstrate has been framed largely with reference to the non-executive director. It was expressed in subjective terms, where the court held that a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience. It moves to remedies for breach of duty. It is a breach of fiduciary duty for a director to wrongfully authorize the transfer of company assets to another company and that his breach lies in the act of signing the transfer forms, not in his failure to make proper enquiries before signing. Corporate governance is considered to be good corporate governance. It is necessary to shed some light on difference between legal systems. The business judgment rule is based on the proposition that directors are charged with the management of the business of the corporation. In order to examine more corporate failures, we are now moving onto the next chapter namely Corporate Governance crisis in the Banking and Finance Sector as it is considered that topic is one of an important topic in this thesis, besides, we may know more clearly the relationship between corporate crisis and the business organization and we go to chapter two to look into the various corporate failures with the issue of corporate governance.

## **Chapter 2**

### **Introduction**

Chapter 2 focuses on the issue of the corporate governance crisis in the banking and finance sector. Financial scandals are explored and rogue traders are explored. The responsibilities of the directors and insider trading are also explored. There are many bank failure such as Barings Bank, Allfirst Bank, BCCI, Lehman Brothers, Northern Rock, Lloyds, HBoS, the Royland Bank of Scotland are examined in this chapter. Besides, there are some non-bank examples, however, they are highly related to our business world. Some of the examples are discussed in detail because we need to explore their real reason of failure. There are lots of

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The result of the case shows that the shareholder will not have a satisfactory form of relief if the institution enters into financial difficulties, and subsequently has to be nationalized. This may encourage shareholders to become more active in the monitoring of the senior management of their given institution to ensure that the institution does not end up within these measures.

information about the examples and it really tell us the main reason of why and how the corporate failure. The problem with the credit rating agencies was not that they were negligent but they were over relied on by the banks and others. There were multiple reasons for collapse with corporate governance. We may find that there is common reason of failure. The key corporate governance implications/insights from these cases are directly or indirectly especially regards to directors' action. The conclusion is how we can prevent the corporate failure in the future.

### **Corporate Governance crisis in the Banking and Finance Sector**

Governments and national institutions all over the world are aware of the important role played by financial institutions and impose regulations on the banking sector. The need for bank regulations is grounded on two basic factors: first, the risk of a systemic crisis that would spread along all the economy; second, the inability of depositors to monitor banks. Despite the regulation that has been imposed on the banking industry, financial firms have received little research effort on key aspects of their functioning. Bankers lend to borrowers that everyone else is lending to, the outcome of a process where the public price of risk is compared with its historic average and a control is applied based on public ratings.<sup>249</sup>

Incentives to risk taking are influenced by ownership structure, investor protection laws and bank regulations. Conflicts of interests between managers and shareholders are argued to be more important in firms with dispersed ownership structures, as coordination problem hinders effectively monitoring of managerial actions by small shareholders, who have to rely on external monitoring through the market for corporate control. By contrast, conflicts between managers and shareholders are expected to be less important in firms with concentrated ownership structures, as controlling shareholders have strong incentives to monitor managers, and replace them in the case of poor performance. Too much monitoring reduces managers' initiative to seek firm-specific investments, which is detrimental to firm value.<sup>250</sup>

Bank supervision arises as an activity capable of overcoming inherent failures of financial markets. In such approach to regulation, bank supervisors have the proper incentives, abilities and the necessary powers to accomplish their purposes of ensuring safety and soundness of the banking system. Supervision plays a role in reducing excessive bank risk-taking and promoting bank performance and stability. In this view, powerful and independent supervisory agencies are desirable, in order to avoid regulators suffering the political pressure of bankers. By contrast, the private interest view assumes that supervisors may use their power to serve either their own private interests or the ones of bankers and politicians. The consequences of powerful supervision in this view are poor bank

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Persaud, A., 'The Inappropriateness of Financial Regulation', VOX, May 2008, available in the website: <http://www.voxeu.org/index.php?q=node/1102>.

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This can be translated in terms of less risk taking by managers at least when ownership concentration is not too high.

performance and increased corruption.<sup>251</sup>

Corporate governance failures which contributed to various financial crimes in major banking institutions and those involved have been held sufficiently accountable in the USA and the UK.<sup>252</sup> We are now going to examine certain organizations failures before we are going to further chapter, as the following organizations shows clearly the negligence of their governance.

## **WorldCom Leadership and Management**

WorldCom successfully acquired a total of 65 companies, of which 11 were acquired between 1991 and 1997, and in that course, has accumulated around \$41 billion in debt.<sup>253</sup> By the time it declared bankruptcy in 2002, the organization had a combined loss of \$73.7 billion.<sup>254</sup> Among other factors, the organization's growth strategy through acquisitions, its loans to senior executives, and poor corporate governance have all contributed to the fall of the company. Through the analysis of Organizational Behavior and principles of management and leadership, the following paper discusses how the WorldCom failure could have been predicted, as well as why it has failed. Following WorldCom's failure and scandals, studies have demonstrated that Bernard Ebbers and Scott Sullivan, the CEO and CFO of the organization at that time, had created an organizational ideology, or culture, in which leaders and managers were not to be doubted or questioned. A great deal of focus was put on team work and being a strong team player, which is said to have been a strategy to reduce dissenting opinions, leading the organization to follow a groupthink attitude. Groupthink is a thought process that individuals tend to adopt when they are deeply involved in cohesive groups where unanimity is the prime objective. The characteristics of groupthink include feelings of invulnerability, moral superiority, group pressure, and self-censorship. As a result, organizations WorldCom Scandal that follow such thought processes tend to inadequately examine alternate course of actions and avoid examining the involved risks.<sup>255</sup>

### **Entrenched Culture**

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Empirical evidence about the effects of supervision on bank lending and risk-taking is limited. However, supervisory assessments and market indicators are not strongly interrelated.

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Peter Yeoh, Corporate governance failures and the road to crime, Article in Journal of Financial Crime 23(1):216-230, University of Wolverhampton, January 2016, abstract.

253

Moberg, D., Romar, E. WorldCom. Retrieved October 12, 2008 from: <http://www.scu.edu/ethics/dialogue/candc/cases/worldcom.html>

254

Romar, E., Calkins, M. (2006). WorldCom Case Study Update. University of Massachusetts-Boston. <http://www.scu.edu/ethics/dialogue/candc/cases/worldcom-update.html>

255

Scharff, M.M. (2005). Understanding WorldCom's accounting fraud: did groupthink play a role?

In addition to the organization's leadership and management approach, there are indications that improper conduct and fraudulent actions were taking place in most levels and parts of the organization. First, the organization's strategic apex participated in fraudulent activities on a regular basis. The strategic apex acted in such a way as to lead the organization's middle line to ignore and commit fraudulent behaviour and was propagated down to the operating core on multiple occasions. As certain email communications illustrated, certain employees part of the operating core was well aware of the accounting irregularities and participated in hiding such practices. The techno structure was at a certain point taking part in this downward spiral of falsified reports and suspicious accounting practices. Their auditors, Arthur Andersen failed to identify the accounting irregularities and did not persist in trying to identify WorldCom Scandal. The organization's ideology had poor values, ethics, and promoted fraudulent conduct. In one instance, following the attempts of certain employees to establish a corporate Code of Conduct, Ebbers, the CEO, reportedly described this effort as a colossal waste of time.<sup>256</sup> In another specific incident, WorldCom's board of directors lent \$415 million from the company's coffers to help Ebbers cover some of his personal debts, mounting to more than \$800 million, in an attempt to avoid a massive sell of company stock by the CEO which would have further driven down the company stock.<sup>257</sup>

## Organizational Structure

In addition to the organizational behavior, WorldCom's organizational structure, or lack thereof, significantly contributed to its failure. In what first seemed to be a successful growth strategy, one significant business reality had not been considered: mergers and acquisitions are costly, time consuming, and represent significant managerial challenges. WorldCom had acquired 11 companies in only six years, from 1991 to 1997, but had failed to properly integrate them in the organization. In fact, following the acquisitions, conflicting and repetitive systems remained and billing systems were not coordinated.<sup>258</sup>

The United States experienced another major corporate collapse in July 2002 with the bankruptcy of WorldCom. The Securities and Exchange Commission had been investigating

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<sup>256</sup>

Ibid

<sup>257</sup>

Pulliam, S., Solomon, D., Mollenkamp, C. (2002). Former WorldCom CEO Built An Empire on Mountain of Debt. The Wall Street Journal. Retrieved October 13, 2008 from <http://academic.udayton.edu/LawrenceUlrich/EbbersAquisition.htm> The UK Stewardship Code (FRC 2010), Principle 1

The UK Stewardship Code (FRC 2010), Principle 3

The UK Stewardship Code (FRC 2010), Preface at p. 1

The UK Stewardship Code (FRC 2010), Preface at p. 1

The UK Stewardship Code (FRC 2010), Principle 3

The UK Stewardship Code (FRC 2010), Principle 5

The UK Stewardship Code (FRC 2010), Principle 6

The UK Stewardship Code (FRC 2010), Principle 7

<sup>258</sup>

Moberg, D., Romar, E. WorldCom. <http://www.scu.edu/ethics/dialogue/candc/cases/worldcom.html>

accounting irregularities at the company, culminating in the admission by the company to falsifications in its accounts. Bernie Ebbers, the former CEO was charged with fraud, conspiracy and making false statements in relation to the accounts; while Scott Sullivan, the former CFO agreed to plead guilty to similar charges.<sup>259</sup> In 1990s, WorldCom was one of the largest companies in the world and its CEO had become a spend-thrift, buying up ranches, yachts and timberlands; in addition to collecting loans from the company at ridiculously low interest rates. There were indications that he and his CFO dominated the board of directors. The actions of the CEO appeared to be unprofessional in many instances and an example is the issue of obtaining loans from the company at unfair interest rates. The failure of WorldCom resulted in a huge loss of confidence on the part of investors. It had devastating effects on the residents of Mississippi in the United States, the home state of the company and the CEO because a lot of those residents had in the spirit of solidarity invested all their financial possessions in WorldCom shares and refused to exit the company until their shares became invariably worthless.

If the directors at WorldCom had behaved more appropriately by being honest and professional in relation to their corporate accounts and dealings, there might have been a more effective corporate governance process in the company and this might have helped prevent or mitigate the corporate failure. Bennie Ebbers was indicted,<sup>260</sup> and convicted in March 2005 of securities fraud, conspiracy and filing false documents with regulators.<sup>261</sup> Scott Sullivan, the former CFO at WorldCom testified against his boss reiterating that he was acting under his instructions.<sup>262</sup> In July 2005, Ebbers was sentenced to 25 years imprisonment.<sup>263</sup> Judge Barbara Jones of the Federal District Court in Manhattan who handed down the sentence stated that Mr Ebbers was the instigator of the \$11 Billion fraud.<sup>264</sup> In rebutting arguments that Mr Ebbers was deceived by his subordinates, she stated that “Mr Ebbers’s statements deprived investors of their money. They might have made

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The Financial Times, 4th March 2004, p 28.

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The indictment at <http://news.corporate.findlaw.com/hdocs/docs/worldcom/usebbers504ind3s.pdf>.

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The report of the conviction at [http://www.forbes.com/2005/03/15/cx\\_da\\_0315ebbersguilty.html](http://www.forbes.com/2005/03/15/cx_da_0315ebbersguilty.html).

262

<http://money.cnn.com/2005/03/15/news/newsmakers/ebbers/>.

263

<http://www.msnbc.msn.com/id/8474930/ns/business/t/ebbers-sentenced-years-prison/>.

264

The article in the New York Times, 14th July 2005 ‘WorldCom Chief is Given 25 Years for Huge Fraud’ at <http://www.nytimes.com/2005/07/14/business/14ebbers.html?scp=12&sq=WorldCom%20court%20case&st=cse>.

different decisions had they known the truth”.<sup>265</sup> This statement underscores the importance of shareholders being in possession of accurate and relevant information regarding their investee companies as it impacts on their decision making in relation to the company. This case appears that there were no good corporate governance and as a result the company was severely suffered from financial loss due to poor supervision.

## **Financial Scandals**

We are going to further examine the financial failures that we have just been discussing. In the first place, we have reason to believe that the company failure, for an example Enron, was mainly due to a combination of factors including corporate governance failure issues.

### **Enron Scandals**

The Enron scandal, revealed in October 2001, involved the energy company Enron and the accounting, auditing, and [consultancy partnership](#) of Arthur Andersen. The corporate scandal eventually led to Enron's downfall, resulting in the largest bankruptcy in American history at the time. Arthur Andersen, which was one of the five largest accounting firms in the world, was dissolved. Enron was formed in 1985 by Kenneth Lay after merging Houston Natural Gas and InterNorth. When Jeffrey Skilling was hired, he developed a staff of executives that, through the use of accounting loopholes, special purpose entities, and poor financial reporting, were able to hide billions in debt from failed deals and projects. Chief Financial Officer Andrew Fastow and other executives were able to mislead Enron's board of directors and audit committee of high-risk accounting issues and pressure Andersen to ignore the issues. Enron's stock price, which hit a high of US\$90 per share in mid-2000, caused shareholders to lose nearly \$11 billion when it plummeted to less than a \$1 by the end of November 2001. The U.S. Securities and Exchange Commission (SEC) began an investigation, and Dynegy offered to purchase the company at a fire sale price. When the deal fell through, Enron filed for bankruptcy on December 2, 2001 under Chapter 11 of the United States Bankruptcy Code, and with assets of \$63.4 billion, it was the largest corporate bankruptcy in U.S. history until WorldCom's 2002 bankruptcy.<sup>266</sup>

### **The manipulation of special purpose entities and Enron's ultimate demise**

Andrew Fastlow, the company's chief financial officer (CFO) engineered the solution to the problem of avoiding the transparency of Enron's increasing debts. This involved the creation of investment partnerships, a form of limited liability partnership. In theory, such a partnership would involve Enron and other investors contributing assets or other consideration to pursue a specific business objective. As distinct legal entities, albeit in effect subsidiaries of Enron, the partnerships had their own legal capacity to borrow funds

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<sup>265</sup>

New York Times Article, Ibid.

<sup>266</sup>

<http://www.webcitation.org/5tZOOq1bE>

from the lending institutions. Many of the partnerships were structured in the form of 'Special Purpose Entities' (SPE). This entitled any debts of the SPE to be kept off Enron's balance sheet. According to the Financial Accounting Standards Board, an SPE could be created where an independent owner of the SPE made a capital investment in the entity and where the independent owner took substantial risks and rewards of ownership, exercising ultimate control over the SPE.

### **Apportioning blame for Enron's demise**

The responsibility for the rapid failure of Enron may be attributed to the failings of the various internal and external corporate watchdogs. These are the company's independent board, the company's auditors, investment banks, credit rating agencies, lawyers, and the Securities and Exchange Commission. In apportioning responsibility for Enron's demise, the greater part of any culpability must rest with the internal watchdogs, namely the directors, executives and auditors. In reality, the Enron case was a 'crony capitalism', in which the ties between the company's management and auditors were so close that little external attention was paid to Enron's financial position, so hidden by aggressive accounting strategies.

### **The auditors' responsibilities**

Although auditors are employed to act to protect investors' interests, their position in the governance structure of a company is one whereby they are placed in a position of conflict. While auditors work to protect the interests of investors, their remuneration is derived from the corporate entity and more specifically in accordance with the decisions and recommendations of the company's management. Auditors may be reluctant to criticize management for fear that they will lose future auditing work. Prior to the collapse of Enron, it had become common practice for accountancy firms to perform auditing work and to act as financial consultants to the company in which they had an auditing responsibility. Enron's audit committee failed to exercise effective corporate governance as it related to the scope of Enron's internal auditing activity.<sup>267</sup>

### **The responsibility of the directors**

In the US, the responsibility for the internal governance of a public company rests on the shoulders of its board of directors. The board comprised a majority of directors who are devoid of day-to-day responsibilities. Both State and Federal laws regulate the directors of a public company. Directors are subject to duties of loyalty and care although in accordance with the business judgment rule, directors operate under the favorable presumption that in making business decisions they will have acted on an informed basis, in good faith and in the honest belief that the decision was in the best interests of the company.

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## **The Enron Board**

Following the Enron scandal, a special committee of Enron's board of directors was set up to investigate the company's demise. The report of the special committee concluded that the board had failed to act with sufficient diligence in its approval of the partnership transactions. Although the non-executive directors of Enron may have been negligent in the performance of their corporate duties, the conduct of the company's executive directors may be described as reckless and, in some instances, fraudulent.

## **Insider trading**

The management and directors of Enron engaged in insider dealing, a prohibited fraud in the US. The practice and timing of stock sales by senior managers and various board members can be viewed as indicative of their knowledge that the company would soon be plagued by financial chaos.<sup>268</sup>

The Enron matter would probably prove to be an important event in the history of American shareholder capitalism. Its future depends on the proper balancing of imperfectly fashioned incentives and self-restraint.<sup>269</sup> The bankruptcy of Enron led to many in Washington debating the way it oversees the \$200 billion power industry. But there is no consensus on erasing the legacy of deregulation that the company's political largess helped forge. Congressional leaders and top regulators are moving forward on what had been Enron's No. 1 objective: a push to reduce local control of electricity transmission lines so that energy merchants like the Enron Corporation can use them to transport and sell power. But the politics of power are shifting, and some of Enron's longstanding opponents - chief among them the Southern Company of Atlanta, which owns many local power monopolies - see a fresh chance to slow deregulation, or even roll it back.

Among those called for inquiries into Enron's collapse at the time were Representative Billy Tauzin, a prominent Republican from Louisiana who is chairman of the House Energy and Commerce Committee; the Senate majority leader, Tom Daschle, and Senator Jeff Bingaman, a Democrat of New Mexico who is chairman of the Senate Energy and Natural Resources Committee. The Bush administration, along with some Democrats - including Mr. Bingaman and William Massey, a Democrat on the energy commission - favoured plans advanced by Enron that would pry open regional electricity markets. The durability of such views was a sign of how effective Enron was during the last decade in keeping Washington at bay as the company pushed to restructure the electricity industry and limit government

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In 2001, insiders sold over \$160 million worth of stock. This was a clear case of the captains' jumping ship.

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Jeffrey N. Gordon, What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections (University of Chicago Law Review, Summer 2002) p18, [http://ssrn.com/abstract\\_id=305343](http://ssrn.com/abstract_id=305343), <http://www.law.columbia.edu/lawec/>.

oversight of new energy markets. Enron and its employees were the largest contributors to President Bush's campaigns over the years, and Enron gave more money to politicians in the last election cycle than did any other energy company. Between 1993 and Enron's collapse, its employees and its chairman, Kenneth L. Lay, donated \$2 million to Mr. Bush. It holds that Enron's business model exemplifies the pathology of the shareholder value system and it is a paradox of our time that shareholder-focused capitalism was harming shareholders.<sup>270</sup>

During the 1990s, Enron grew from a small domestic Texan energy company to become one of the largest United States corporations, taking advantage of deregulation and globalisation to create opportunities which translated to profit and growth. It was a company run by respectable persons with huge political connections and had been ranked for several years in a row as Fortune magazine's most innovative company. It collapsed, due to disclosures of non-existent transactions which were placed as off balance-sheet items and consequently, estimated incomes which would never materialise. The company filed for bankruptcy on 2 December 2001 resulting in the loss of thousands of jobs and over \$1 billion of its employees' retirement savings. In a paper by Sherron Watkins, a former vice president of Enron and the "whistle blower" at the company before its collapse, there is an account of how Kenneth Lay, a Chief Executive Officer (CEO) at Enron would preach the company's core values of respect, integrity, communication and excellence (RICE); and would not live up to its tenets by getting involved in situations such as compelling Enron employees to patronise his sister's travel agency constantly when that agency did not provide affordable and excellent service.<sup>271</sup> Mr Lay's actions suggest that he was a person who did not abide firmly by the values of integrity and professionalism.

Jeffrey Skilling was CEO of Enron between February and August 2001. He was described as someone who infused a new business image into the company, one that placed emphasis on generating profit, regardless of the cost. This resulted in the company recruiting only the brightest traders and rewarding achievement with outrageous salaries and bonuses; with Mr Skilling instituting a Performance Review Committee which became known as the harshest employee ranking system in the United States.<sup>272</sup> The core values of the company were relegated to the background and replaced with a relentless drive towards profit making, a situation which could result in a negation of professionalism in the long run, as occurred at Enron. The Chief Financial Officer (CFO) of Enron, Andrew Fastow, set up three partnerships that engaged in business transactions with Enron and formed part of the reason

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Deakin, S, "Corporate Governance after Enron: the Return to History", (2005), Economic and Social Research Council, The Edge, Issue 14, p 27.

271

See the address of former Enron vice president Sherron Watkins at the Academy of Management on 3rd August 2003, available in the Academy of Management Executive, Vol 17(4), p 123.

272

C.W. Thomas, 'The Rise and Fall of Enron' (2002) 193(4) Journal of Accountancy 41-53.

for the losses that the company disclosed eventually.<sup>273</sup> It is difficult to think that the company directors at Enron could not have known the level of conflict of interest that would result in a situation in which its CFO is consummating business transactions between a company he works for and a partnership he owns.

Andrew Fastow was lobbying the rating agencies to provide Enron with positive credit ratings to attract investment. Such behaviour indicates that these company directors lacked integrity. Enron directors reneged on their duties and responsibilities, which contributed to ineffectiveness in the governance of the company. There are various accounts of huge salaries and bonuses earned by the executives, with Andrew Fastow earning over \$30 million in management fees for his partnerships. They indulged in selling off their own shares whilst telling other employees that the company was performing optimally before they filed for bankruptcy. Aside from the obvious cases of numerous job losses and financial crippling of employees that the Enron collapse brought about, many other companies were affected by its failure, examples include Arthur Andersen (its auditors), JP Morgan Chase, Citigroup and Merrill Lynch. One of the most far reaching consequences of the fall of Enron would be the death of one of its former executives, J Clifford Baxter. He had complained to the CEO about questionable accounting practices within Enron, but, upon being called to testify before the United States Congress, he committed suicide in order to avoid the embarrassment.<sup>274</sup>

In the original indictment of the Enron executives, Richard Causey, Kenneth Lay and Jeffrey Skilling were charged on 53 counts with various issues ranging from issuing fraudulent and misleading statements, conspiracy, securities fraud, money laundering, bank fraud, wires fraud and insider trading.<sup>275</sup> The Enron Examiners' Report concluded that certain senior officers engaged in wrongful conduct and violated their duty of loyalty to the company.<sup>276</sup> In the US Senate Report on the role of the Enron Board of Directors, it was stated that the directors breached their fiduciary duties because they witnessed numerous indications of questionable practices by Enron management executives over several years but chose to ignore them to the detriment of the company shareholders, employees and business associates.<sup>277</sup> The US Senate Report concluded that the board of directors contributed to the failure of Enron because the issues which plagued the company such as high risk accounting

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J.R. Macey, 'Efficient Capital Markets, Corporate Disclosure and Enron' (2004) 89 Cornell Law Review 394; see Wearing, 69; see Mclean & Elkind, 120.

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R. Tomasic, 'Corporate Collapse, Crime and Governance- Enron, Andersen and Beyond' (2002) 14 Australian Journal of Corporate Law 183.

<sup>275</sup>

The indictment document at <http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/usvlay70704ind.pdf>.

<sup>276</sup>

The Examiners' Report (Role of Enron's Officers) at <http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/enronbk72803app-c.pdf>, 94-95.

practices, inappropriate conflict of interest transactions, extensive undisclosed off the book transactions and excessive executive compensation were all facts within the knowledge of the directors who failed to provide sufficient oversight and restraint of management excesses as required by their obligations.<sup>278</sup> In May 2006, Jeffrey Skilling was found guilty on 19 counts of conspiracy, fraud, false statements and insider trading. Kenneth Lay was found guilty on 6 counts of conspiracy and fraud; and Judge Sim Lake ruled that Mr Lay was guilty of 4 counts of fraud and false statements. After the indictment, Richard Causey pleaded guilty. Kenneth Lay died in July 2006 before sentencing was concluded and before a notice of appeal could be filed, and the court vacated his conviction and dismissed his indictment upon a motion brought by his estate.<sup>279</sup>

The judgment and sentencing was made in respect of Jeffrey Skilling who was committed to an imprisonment term of 292 months.<sup>280</sup> Jeffery Skilling appealed against his conviction on grounds which included that he did not get a fair trial from the jury which was constituted in Houston, the venue of the crime and the court proceedings. In June 2010, the US Supreme Court vacated his appeal on the grounds of a fair trial but upheld his appeal on the grounds of the honest services statute upon which his conspiracy conviction was based.<sup>281</sup> The jurors in the first trial noted the flaw in the character and personality of the Enron executives.<sup>282</sup> The jurors refused to believe that the executives were telling the truth when Jeffery Skilling and Kenneth Lay claimed that they did not know that things were going wrong at Enron. The jurors noted that it was appalling that Mr Lay was selling his own Enron shares even as he assured employees and shareholders that the company was fiscally sound. One of the jurors commented as follows that was the character of the person that he was.<sup>283</sup> The jurors stated that Mr Lay put his personal financial welfare ahead of his duties to the shareholders

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The Senate Report at <http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf> , 3.

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The Senate Report, Ibid.

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The Order of Vacation at <http://www.txsb.uscourts.gov/notablecases/enron/404cr25/laydismissal.pdf>.

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The Judgment and Sentencing at <http://www.txsb.uscourts.gov/notablecases/enron/404cr25/judgment.pdf>.

281

The US Supreme Court Opinion at <http://www.supremecourt.gov/opinions/09pdf/08-1394.pdf> .

282

The article in the New York Times, 26th May 2006 'Enron Jury Unswayed by "I Didn't Know"' at <http://www.nytimes.com/2006/05/26/business/businessspecial3/26jury.html>.

283

Ibid.

and employees.<sup>284</sup> The Enron collapse represented a remarkable event from many points of view. It was probably the biggest bankruptcy in history<sup>285</sup>, its proportions and consequences being unprecedented. What is more striking is the impact it had on the American capitalist system as a whole and on that corporate governance system that was considered a sophisticated and safe operational platform for corporations worldwide.<sup>286</sup>

In the 1990s, when American stocks were leading the world and index peaked at record heights, Enron was at the zenith of its growth and was acclaimed as one of the most innovative firms on the market by the Wall Street financial press.<sup>287</sup> Enron stock prices continued a spectacular rise until 2001, when a series of revelations concerning accounting frauds and executives misconducts led the way to the historical fall of the seventh largest corporation of the United States and six-time winner of Fortune Magazine's award. Enron's downfall was followed by other scandals, among which WorldCom, Tyco and Adelphia, which presented similar patterns in the way the frauds had been committed through accounting irregularities.<sup>288</sup> The consequence to the scenario was a loss of confidence in the stock market, especially from those groups who suffered the heavier losses after the scandal, like employees, whose pension schemes were tied to the share value of the company. The reaction was prompt from American authorities, since the Congress enacted a new piece of legislation, known as Sarbanes-Oxley Act<sup>289</sup>, just few months after Enron filed for bankruptcy. In analysing the Enron scandal, it is possible to single out two reasons of the corporate failure: on one hand the corporate governance failure, especially with regards to the role of gatekeepers who did not prevent the making of the frauds and sometimes contributed to the structuring of fraudulent transactions. On the other hand, irrational and

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Ibid.

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It was the biggest bankruptcy in the US history, costing 4.000 employees their jobs, and leaving an estimated \$23 billion in liabilities, both debt outstanding and guaranteed loans, with a stock price falling from over \$90 to \$0,61. See "The 15 Largest Bankruptcies 1980 – Present", [www.BankruptcyData.com](http://www.BankruptcyData.com).

286

The Anglo-American "outsider model" of corporate governance, coupled with global capital markets was supposed to be the most competitive model, especially when compared to the "insider" system of European countries. See H.B. Hansmann and R. Kraakman "The End of History for Corporate Law" 89 *Georgetown Law Journal* 439 (2001).

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N. Stein "The World's most admired companies. How do you make the most admired list? Innovate, innovate, innovate!", *Fortune* magazine, October 2, 2000.

288

J. Armour and J.A. McCahery "After Enron: Improving Corporate Law and Modernising Securities Regulations in Europe and the US", Amsterdam Centre for Law and Economics, Working Paper no. 2006-07.

289

Public Company Accounting Reform and Investor Protection Act 2002, known as Sarbanes-Oxley Act.

risky managerial strategies led to the serial application of financial transaction that led to collapse. A brief account of the rise and fall of the Texas corporation will help defining the legal issues underlying this financial scandal. Enron was formed in 1985 through the merger of two gas companies, Houston Natural Gas and InterNorth. Kenneth Lay, founder, Chief Executive Officer and Chairman of the company had been keen on that ideology and through his lobbying power in Washington he participated in the crusade for deregulation laws to be passed, in order to “liberate businessmen from the rules of regulation of government”.<sup>290</sup>

Under Skilling’s leadership Enron developed the new idea of working as a “Gas Bank”, operating as intermediary between suppliers and end-users in the gas market.<sup>291</sup> In the 1990s it became clear that the focus of Enron business was rather in the trading operations of financial securities based on energy commodities, than in the trading of physical assets. The growth during this period was related to and dependant on acquisitions in the energy market and on capital investments which took years to deliver significant earnings. A key aspect of Enron strategy and of its governance structure was the vast use of Special Purpose Vehicles (SPV) made by the management. SPVs were structured as separate entities to which Enron would contribute assets, in order for the SPV to borrow from capital markets, issuing securities to investors backed by the underlying assets contributed by Enron. Such schemes would guarantee an investment grade credit rating that was vital for Enron to maintain trading operations.<sup>292</sup> These transactions, coupled with a corporate governance structure, gave way to the financial engineering that led the Houston group to bankruptcy.

The accounting problems came to light in 2001 as Enron had to restate its financial statements for the period 1997–2000 to reflect the consolidation of some unconsolidated SPVs. This event generated concerns from the specialised press about the company and its financial problems, since the firm’s debt ratio had not reflected the situation of the unconsolidated SPVs.<sup>293</sup> Although Enron’s profits started declining by the end of the 1990s, the public became aware of the firm’s financial difficulties only in 2001, when Enron’s share price dropped to less than a dollar in November. It is safe to state that the firm’s decline was a quick one, regardless of the public perception, for two main reasons. Firstly, the long-term contracts that Enron concluded with its counterparts entailed an element of trust that Enron could perform its obligations throughout the term of the contract; once Enron’s credit rating declined, its counterparts refused to trade, withdrawing their cash balances held with Enron

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See B. McLean and P. Elkind, “Enron: The Smartest Guy in the Room”, Portfolio 2003.

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S.L. Gillian and J.D. Martin “Financial Engineering, Corporate Governance, and the Collapse of Enron”, Centre for Corporate Governance University of Delaware, Working Paper Series 2002-001, p.5,6.

292

This resembles the structure of securitisation transactions, even though it is argued that the transactions in place at Enron are not classifiable as securitisation. S.L. Schwarcz “Securitization Post-Enron”, Duke Law School Research Paper No. 38, 2003, p.9,10.

293

Supra Gillian and Martin 2002, p.11.

and requiring cash collateral. These actions created financial pressure as well as a liquidity crisis. Secondly, what enhanced Enron's vertical decline was the exposure to contingent liabilities related to its off-balance sheet SPVs. Once the credit problems appeared in their magnitude, Enron's ability to obtain credit and support its trading vanished completely and brought the business to a halt.<sup>294</sup>

On paper the Enron board was a perfect one – especially when compared to some continental counterparts, like the Parmalat board – composed by fourteen members, of whom only two were insiders<sup>295</sup>; most of the outsiders had business experience in the fields of finance and accountancy, and in management roles in other boards. Most of the directors owned stock in significant amount as they all received stock options as part of their compensation schemes.<sup>296</sup> It is pointed out that the audit committee had a state of the art charter which made it the overseer of the company's reporting process and internal controls with direct access to financial, legal, and other staff and consultants of the company, and the power to retain other accountants, lawyers, or consultants as it thought advisable. Enron's board structure appeared to be at the leading edge of best governance practice, as confirmed by the review of best corporate boards where the Chief Executive Magazine included Enron among the five top boards in the US.<sup>297</sup> In the aftermath of the scandal, it was reported by the Enron Special Investigation Committee that the board had been inefficient in its main duties with regards to the audit committee. The acclaimed independence of its directors was compromised by conflicts of interest arising as a consequence of side-payments and by bonds of long service and familiarity.<sup>298</sup> A peculiarity of the Enron governance which serves as an explanation to the conflicts of interest is the sui generis structure that allowed the Chief Financial Officer Andrew Fastow to run independent entities that entered into risky and volatile transactions worth billions of dollars. Other senior officers were allowed to profit from self-dealing transactions<sup>299</sup>, without the supervision or the full understanding of the

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Ibid.

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The two insiders were the Chairman and former CEO Kenneth Lay and the CEO Jeffrey Skilling.

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J.N. Gordon "What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections", Columbia Law School, Centre for Law and Economic Studies, working paper no. 203/2002, p.4.

297

Supra Gillian and Martin 2002, p.22. The board subcommittees included audit and compliance, compensation and management development, executive, finance, and nominating and corporate governance.

298

J.S. Lublin "Inside, Outside Enron, Audit Committee is Scrutinized", Wall Street Journal 2002 C1.

299

Supra Gillian and Martin 2002, p.23. See S. Shapiro "Collaring the Crime, not the Criminal: Reconsidering the Concept of White Collar Crime", American Sociology Review, 1990 Vol.55 (346 – 365).

board concerning their outcome. These transactions were realised through a complicated network of subsidiaries employed in off-balance sheet partnership with Enron.<sup>300</sup>

The US Senate investigation on the role of the Enron board in the company's collapse, sought to address the issue of directors' independence. The findings confirmed that highlighting numerous financial ties between the company and certain directors, especially in the form of consulting fees paid in addition to board fees, and transactions with entities in which directors played a central role.<sup>301</sup> It has been suggested that six out of twelve non-executive directors had conflicts of interest through financial ties, and most of these directors were members of the audit and finance committees, enhancing the detrimental effects of their conflicts of interest.<sup>302</sup> Another aspect of the Enron governance system that can be pointed at as a reason for the board's inefficiency is the compensation policy. The appointment of directors of public corporation, when sitting in high profile committees, often require remuneration, the high compensation can have the two-side effect of hindering directors' critical approach and independence, since a sharp questioning of management's decisions may play against re-appointment.<sup>303</sup>

Stock-based compensations can produce undesired effects since pursuing and protecting the share price can lead to decisions conducive to conflicts. The importance and the advantage of stock option as a means to align managers' and shareholders' different goals can be compromised by the level of stock option granted to managers. An excess in the amount of option can bring about two problems which have been at work in the Enron case: the fraudster and the risk-preferring executive.<sup>304</sup> It is observed that managers with high levels of options have incentives to get the share price high, by any possible means, fraud included<sup>305</sup>; and that can be achieved through risky practices that can diminish the value of

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J. Coffee "Understanding Enron: It's about Gatekeepers, Stupid", Columbia Law School, The Centre for Law and Economic Studies, working paper 207-2002.

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Supra Gordon 2002, p.12,13.

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Ibid.

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L.A. Bebchuk and Y. Grinstein "The Growth of Executive Pay", Harvard John M. Olin Centre for Law Economics and Business, discussion paper No. 510 2005.

304

Supra Gordon 2002, p.14. See D. Skeel Jr. "Icarus and American Corporate Regulation", in "After Enron: Improving Corporate Law and Modernizing Securities Regulations in Europe and the US", by J. Armour and J.A. McCahery, 2007.

305

Supra Gordon 2002, p.15.



the firm itself, but increase the value of managers' firm-related investments.<sup>306</sup> Stock option compensations played a central role at Enron and it has been suggested that the range and amount of stock options was far higher than the average of Enron's peer group. This can be read as a reason behind some board's behaviour, namely the attenuation of careful monitoring of management practices, especially concerning those designed to preserve the firm's credit rating.<sup>307</sup>

The Enron board was deficient in its controlling functions and this trend is evident with regards to transactions involving the approval of SPVs and the monitoring of those partnerships. At several junctures the board ignored red flags that could have restrained certain managerial actions that led to the collapse.<sup>308</sup> As part of the broad governance failure, the breakdown of gatekeepers' functions became evident during the years between Enron and Parmalat, with most of these scandals exposing malfunctions in the areas of accounting and audit most prominently. This label led to the prompt enactment in the US of the Sarbanes-Oxley Act in 2002. Enron has been referred to as demonstration as well as the peak of gatekeepers' failure, which in turn raises the question of how to rectify this governance breakdown.<sup>309</sup> The role of gatekeepers<sup>310</sup> within corporate governance should be to assess a corporate client's own statement or a specific transaction.

In the United States the role of statutory auditors was defined with the Securities Act 1933 and with the Securities Exchange Act 1934, at a time when the markets had been hit by the Great Depression. These Acts required companies issuing securities in the stock markets to have their financial statements certified by professional and independent accountants, acting within that function as watchdogs in the public interest.<sup>311</sup> In theory this public interest function should be supported by the fact that gatekeepers have less incentive to lie than their clients, and their evaluation of facts should be trustworthy. Credibility stems from what is

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Ibid.

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P. Healy "The effect of bonus schemes on accounting decisions", *Journal of Accounting and Economics*, 7 85-107 1985.

308

Supra Gillian and Martin 2002, p.25; it is interesting to note that in October 2001 the Wall Street Journal suggested that Fastow had earned more than \$7 million through compensations from one of the SPVs he had created; previously a report from the finance committee had requested information about Fastow's compensation, but when the information was not provided by the senior compensation officer, the matter was dropped.

309

Supra Coffee 2002, p.6.

310

Ibid

311

Supra Gillian and Martin 2002, p.27, 28.

defined the reputational capital that gatekeepers pledge and which is attained after many years of performing the same services for a number of clients. The assumption is that gatekeepers would not sacrifice their reputational capital for a single client and for a fee which is deemed to be modest when compared to the whole clients' portfolio.<sup>312</sup> Evidence from the last decade shows a different picture and suggests that gatekeepers do acquiesce and sometimes contribute to the fraud perpetrated by their clients, even though this behaviour may seem irrational and not in line with the above assumption.<sup>313</sup>

Arthur Andersen was Enron's auditor at the time of the collapse and the firm could count on a portfolio of around 2.300 audit clients; it seems that they had little incentive to risk such a reputational capital for one client, as big as Enron could be.<sup>314</sup> This reputation theory represents a landmark within courts' interpretation on these matters, as documented by Judge Easterbrook in *DiLeo v. Ernst & Young*. Arthur Andersen – a firm that could boost revenues for over \$9 million in 2001 – became involved in a series of securities frauds in the 1990s that in the last few years of its life culminated with the association with the Enron scandal. During the 1990s the standard of financial reporting went down, with an increasing average of earning restatements by public companies that indicated that previous earning management had gone out of hands. The big accounting firms had earlier acquiesced in earning management – premature revenue recognition above all – that could no longer be sustained.<sup>315</sup> This trend can be extended to other consulting functions beyond the audit. Securities analysts were more jeopardised after Enron since in 2001 sixteen out of seventeen analysts were recommending a buy or a strong buy on Enron's stock.<sup>316</sup> The desire to retain some sort of reputation and to be perceived as credible and objective was in that case superseded by the necessity to please investment banking clients.<sup>317</sup>

It is assessable within the study of the Enron collapse that none of the watchdogs, who could have detected signs of the frauds, when the downfall was inevitable. Two different

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Supra Coffee 2002, p.6.

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R.A. Prentice "The Case of the Irrational Auditor: A Behavioural Insight into Securities Fraud Litigation", 95 Nw.U L Rev. 1333 (2000). See P. Davies "Enron and Corporate Governance Reform in the UK and the EC", in "After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US" by J. Armour and J.A. McCahery, 2007.

314

Supra Coffee 2002, p.7.

315

Supra Coffee 2002, p.11,12.

316

Ibid.

317

Ibid.

explanations have been proposed for this collective gatekeepers' malfunction that compromised the overall corporate governance system.<sup>318</sup> The theory focuses on the decline of the expected liability costs arising out of acquiescence by auditors. The benefits of acquiescence rose as a result of the big audit firms' strategic behaviour in the market, since they combined multiple consulting services, using the audit as a portal of entry to get big clients. This combination of consulting services with audit services enabled clients to exercise a form of pressure over the audit firm in a low visibility way. Without having to fire the audit firm and incur in public embarrassment and investigations, the client who was dissatisfied with the auditor's intransigence, could terminate the consulting relationship, depriving the audit firm of the largest source of revenue.<sup>319</sup> The explanation relates to the market bubble of the 1990s, during which the stock prices kept soaring, gatekeepers were seen as troublesome from management's perspective as their red flags would have dissuaded potential investors. This same explanation can be applied to securities analysts who were overwhelmed by the boom of the IPO market and became the means by which investment banks could compete for IPO clients as underwriters.<sup>320</sup> Understanding Enron from the perspective of gatekeepers' failure would entail a minimum level of understanding of American accounting rules, which differ from those in place in most other jurisdictions. The widespread reaction to this was that the SEC called for a principle-based system, which would require the auditor to not simply certify compliance with the Generally Accepted Accounting Principles, but rather to confirm that the issuer's financial statement reflected its financial position.<sup>321</sup>

Enron lied in certain managerial strategies and risky transactions employed. Structured finance<sup>322</sup> is a difficult area of law to understand and transactions therein are not easy to asses as regards the risk they entail. Off-balance sheet financing, mainly in the shape of securitisation, represented a key tool for the Enron management to raise finance through capital markets, coupled with high-risk derivatives transactions. The idea reflected by the Enron management in hindsight, is that it employed different means to disguise the rapid rise of debts: Enron was consistently hedging<sup>323</sup> part of its investments through the use of

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Ibid.

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Ibid. See S. O'Conner "The Inevitability of Enron and the Impossibility of Auditor Independence under the Current Audit System", available at [ssnr.com/abstract=303181](http://ssnr.com/abstract=303181), 2002.

320

Supra Coffee 2002, p.17.

321

Ibid.

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See SEC Rule 434; Securities Act Release No.42746 (May 2 2000).

structured finance transactions, with the purpose of minimising financial statement losses and avoid to add debt to its balance sheet as this would have damaged the credit rating.

The SPV would hedge the value of a particular investment on Enron's balance sheet, using Enron's assets as source of payment.<sup>324</sup> What the management at Enron did not predict was the fall of its stock value, which of course entailed the plunge of the SPVs' value as well; this in turn triggered the payment of the guarantees provided by Enron since the SPVs would lack at that point 12-sufficient assets to perform their hedge.<sup>325</sup> Another consequence of the decline in share value was the breach of the three percent independent equity requirement for non-consolidation<sup>326</sup>, which added the SPVs' debts to the alarming Enron's balance sheet.<sup>327</sup> The problem with the use of SPVs related to the huge level of contingent liabilities that were not consolidated with the company's balance sheet. Enron was funding its growth through the syndication of capital investments in off-balance sheet SPVs.<sup>328</sup>

An example that illustrates this form of hedge transactions is given by the relationship between Enron and LJM Cayman L.P., an entity formed in 1999 by CFO Andrew Fastow who served as its general partner, in breach of the Enron's code of conduct and generally of the fiduciary duties that bound him to the company.<sup>329</sup> LJM was created with the purpose to raise funds in order to hedge Enron's merchant investments in other partnerships and to acquire other assets in Enron's merchant portfolio. Among the transactions between Enron and LJM, one raised concerns as it represented the first time that Enron transferred its own stock to an SPV and used the SPV to hedge the value of a merchant investment.<sup>330</sup> The background for this hedge was a \$10 million investment in a partnership called Rhythm

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In finance hedge is an investment that is taken out to reduce or cancel the risk in another investment.

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Supra Schwarcz 2002, p.1311.

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Ibid.

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F. Partnoy "Enron and Derivatives" EFMA 2003 Helsinki Meetings, available at SSRN: <http://ssrn.com/abstract=302332>.

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Supra powers Report.

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Supra Gillian and Martin 2002, p.17.

329

Supra Schwarcz 2002, p.1312.

330

Ibid.

NetConnection in 1998; a year later Rhythms went public and the Enron management decided to hedge the unrealised gains of around \$300 million. The solution to avoid any decline in Rhythm stock to be reflected on Enron's income statement, was to hedge the Rhythm investment with LJM.<sup>331</sup> It is worth pointing out that LJM's funds came in part from Fastow and from other investors, while the remainder came from the use of trapped value of forward contracts<sup>332</sup> which the company had entered into with investment banks to purchase its own shares. When the company tried to release the value of the forward contracts in order to keep it as income, this implied another intricate procedure: firstly, settling the forward contracts in return for shares of Enron stock; secondly, selling these shares to LJM for a note receivable and then a put option<sup>333</sup> on the Rhythm shares. The point of this transaction was that the LJM's ability to honour the put option was contingent on the value of the Enron stock it owned; it can be said that the value of Enron's Rhythms put was relying on Enron's share price itself. The put option was utilised as a device to hedge earnings and resulted in no economic gain to Enron.<sup>334</sup>

Other similar transactions were carried out between Enron and its SPVs, with similar objectives. These transactions were referred to as "Raptors" and had great impact on Enron's balance sheet, through the use of derivative transactions that followed the same structure outlined. The difference is that some of these Raptors took the form of total return swaps<sup>335</sup> on Enron's interests in merchant investments, with the consequence that the arrangement would have worked if the SPVs had the capacity to meet their obligations. But this capacity depended on the value of the SPV's principal asset, which was Enron stock.<sup>336</sup> When the value of Enron investments started to fall, this caused the Raptors to suffer losses since the hedges were based on those underlying investments; similarly, as Enron's share price declined, the Raptors' ability to honour the hedge was compromised.<sup>337</sup> It has been

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Supra Gillian and Martin 2002, p.14.

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P.R. Wood "Title Finance, Derivatives, Securitisation, Set-off and Netting", Sweet and Maxwell London 1995, ch.2.

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Options are financial instruments that convey the right, but not the obligation, to engage in a future transaction on some underlying security, or in a futures contract. Supra Wood 1995, ch.2.

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Supra Gillian and Martin 2002, p.16.

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A swap is a derivative in which two counterparties agree to exchange one stream of cash flows against another stream. These streams are called the *legs* of the swap. Supra Wood 1995, ch.2.

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Supra Gillian and Martin 2002, p.17.

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observed before the United States Congress that by the time the bankruptcy became public, Enron had developed from an energy firm into a derivatives trading firm, and that could be recognised by the characteristic layout of the new building where the top floor was overlooking the derivatives trading pit below.<sup>338</sup>

Derivatives are complex financial instruments that belong to the finance world more than to the legal one and for this reason they appear too impenetrable to be understood by the investor. The value of derivatives is based in fact on one or more underlying variables, like the price of stock or the cost of natural gas; the market for derivatives where Enron engaged is an unregulated one, since under US securities law, derivatives were not deemed securities and were not audited.<sup>339</sup> Enron used derivative transactions to manipulate its financial statements and this happened in three ways: firstly, by hiding huge losses suffered on technology stocks; secondly, by hiding debts incurred to finance unprofitable new ventures; and thirdly, by inflating the value of other troubled businesses. It can be observed that most of these derivatives transactions did not involve energy at all.<sup>340</sup>

When the value of Enron's stock collapsed, the SPVs were unable to perform the hedge as expected.<sup>341</sup> After the Enron scandal unfolded in all its magnitude, European markets felt somewhat relieved and vindicated that such a sequence of corporate failures had occurred on the other side of the Atlantic. There was a feeling that the American corporate governance system was immune from such malfunctions and the balance of powers in place would have prevented similar events. Americans had looked at European corporate governance as a system jeopardised by underdeveloped capital markets and by ownership structures that did not allow full growth of corporate power.<sup>342</sup> The Enron bankruptcy proved the point of those who had highlighted the greed of American executives and the overwhelming power that they enjoyed within corporations as a threat that could lead to frauds; the same scenario in continental Europe would have been hindered by that same denigrated ownership

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Ibid.

338

Supra Partnoy 2003.

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L.A. Stout "The Legal Origin of the 2008 Credit Crisis", Working paper February 2011, available at <http://ssrn.com/abstract=1770082>.

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Supra Partnoy 2003.

341

Supra Schwarcz 2002, p.1315.

342

G. Sapelli "Giochi Proibiti, Enron e Parmalat Capitalismi a Confronto", Bruno Mondadori 2004, Ch.1.

structure.<sup>343</sup> It appears that the corporate governance flaws in the Enron / WorldCom cases could be eliminated and subsequently they led to Sarbanes-Oxley Act.

## **Parmalat**

Parmalat was uncovered as one of the most astonishing financial frauds in history, involving what was considered a stronghold of Italian industry, affecting a group with more than 200 companies and some 36,000 employees, and above all opening up the floodgates to what appeared to be a fraud carried out for more than a decade. What triggered the insolvency was a communication sent by Bank of America to Parmalat's auditors Grant Thornton, stating that the document confirming a bank account for a Cayman Island company was a forgery. This company was supposed to hold almost €4 billion of Parmalat's group, but the money had never existed in real.<sup>344</sup> Parmalat was founded in 1961, in Parma, mainly as a family business operating within the food trade. Its founder, Calisto Tanzi, appeared to be driven by a desire to expand the business and the first chances to do so were represented by the commercialisation of pasteurised Ultra-Heat Treatment milk, which had a long shelf life and was suitable to be exported to distant destinations.<sup>345</sup>

Tanzi was a pioneer in taking advantage of the Tetra Pak packaging process which, by the beginning of the seventies, allowed Parmalat to gain a strong position in the dairy industry.<sup>346</sup> The big leap anyway took place in the eighties, when the group started pursuing a policy of expansion into foreign markets, mainly in South America, and consolidated a position of market leader in Italy. During this period, Tanzi tried to venture into new and different markets, from the TV one, to tourism and sport. These ventures proved to be critical for the group and marked the beginning of the group's financial difficulties. The enterprises in the TV business<sup>347</sup> and tourism confirmed to be a complete fiasco and the low margins of profit generated by the dairy production were not sufficient to match the high expenditures required for the new investments. The strategy to be pursued at that stage was to resort to the public market and conduct what is referred to as a reverse merger<sup>348</sup>, which was achieved

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M. Landler "Scandal Outrages Europeans; Solutions May Be Patchwork", N.Y. Times, Dec. 25 2003, at C1.

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M. Gerevini "Parmalat, ecco il fax che segnò la fine di Tanzi", Corriere della Sera, December 18 2004.

345

C. Storelli "Corporate Governance Failures: is Parmalat a European Enron?", 765 Columbia Business Law Review 2005, p.779.

346

P. Dalcò and L. Galdabini "Parmalat, il Teatro dell'Assurdo", Food Editore 2004, ch.2.

347

G. Ferrarini and P. Giudici "Financial Scandals and the Role of Private Enforcement: The Parmalat Case", ECGI Working Paper Series in Law, 40/2005, p.6.

348

by acquiring 51% of Finanziaria Centro Nord, a public company whose stock was traded on the Milan Stock Exchange. This transaction gave Tanzi the opportunity to access the public market with the new corporate vehicle – Parmalat Finanziaria SpA – of which he maintained control.<sup>349</sup> The merger served several purposes, firstly, obtaining funds without a dilution of ownership and secondly, incurring less costs and thirdly, a lower degree of disclosure than a direct IPO would have entailed.<sup>350</sup>

It was that Parmalat's managers began cooking the books, making in other words major adjustments to the accounts in order to give a healthier image of the company. This practice was carried out by forging documents and through a variety of transactions whereby fabricated receivables recordable as assets were sold to SPVs.<sup>351</sup> Off-balance sheet financing, in the form of securitisation, became in this phase a common tool for Parmalat's CFO Fausto Tonna, to hide losses and create accounting dumps.<sup>352</sup> This mechanism needed to be nourished because of the amount of interest rates to be paid on the various loans. Parmalat went on pursuing its policy of issuing bonds, but when in 2002 they issued a €306 million convertible bond which caused their stock price to fall. Market observers<sup>353</sup> started to wonder why Parmalat was borrowing, adding debt at a high rate, when its books showed profits and cash available for €1.4 million.<sup>354</sup> In 2003 CONSOB<sup>355</sup> increased its controls on the group, following a negative stock market reaction to another attempt to issue bonds.

The fall in stock price was related to a poor quality of disclosure that characterised Parmalat management and the relationship with those gatekeepers who were trying to acquire

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W.K. Sjostrom "The Truth About Reverse Mergers", *Entrepreneurial Business Law Journal*, Vol. 2, 2008.

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Supra Storelli 2005, p.771.

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It needs to be pointed out that with the enactment of the EU Transparency Directive 2004/109 the above scheme would have not sorted the same effects.

351

Supra Storelli 2005, p.774-776.

352

Ibid.

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Supra Ferrarini and Giudici 2005, p.9.

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Supra Storelli 2005, p.776.

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Commissione Nazionale per le Società e la Borsa, the equivalent of SEC in the USA.



information.<sup>356</sup> This attitude forced the group to attend a meeting with both CONSOB and Banca d'Italia in order to explain their policy and clarify the reasons behind the strategy of issuing bonds at very unfavourable conditions. At the meeting they announced that the CFO had resigned and a new one had been appointed, Alberto Ferraris, a former Citi Group employee. This move was essential to the group's strategy since the new CFO, thanks to his contacts in the banking industry, launched a wave of private placements, procuring the services of Bank of America and Deutsche Bank.<sup>357</sup> The investment banks' help did not solve Parmalat's troubles; when Deutsche Bank announced a new private placement in September 2003 Standard & Poor lowered the group's credit rating to a level just above junk status.<sup>358</sup> When the company was requested by CONSOB to be more explicit about its accounts, more pressure mounted on the auditors, especially on the external ones Deloitte. They stated that they were not in a position to give a fairness opinion of Parmalat's true value, since there was a grey area represented by a mutual fund in which the group had participation and by some complex swap transactions with the fund itself. Another finding came to light as one of the group's subsidiaries had entered into an obscure contract with a SPV created by Citi Group: Buconero.<sup>359</sup>

Parmalat's agony came to an end when in December 2003 some of the bonds were due and the company publicly declared that they could not service them. The credit rating was downgraded to junk status and Grant Thornton, acting as second auditor, was requested by CONSOB to investigate on a company in the Cayman Islands called Bonlat, which was supposed to hold €3.95 billion of the group's cash. As said at the beginning of this account, the fraud unfolded at this stage.<sup>360</sup> Enrico Bondi was appointed commissioner; his attempt to try to establish the true status of the group's consolidated balances, brought to a shocking result: there were debts for €14.3 billion and a complete lack of liquidity, which sharply contrasted with the group's latest balance sheet. As the group's insolvency procedure started, litigations commenced both on the criminal side in 2004, and on the civil side in 2005, involving 27 defendants and some 7000 investors as plaintiffs.<sup>361</sup> The corporate

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G. Capolino, F. Massaro, P. Panerai "Parmalat: La grande Truffa", Milano Finanza 2004, p.118-120.

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Supra Ferrarini and Giudici 2005, p.11.

358

Supra Storelli 2005, p.778.

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Supra Storelli 2005, p.779.

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Supra Capolino et Al. 2004, p.168.

361

Supra Ferrarini and Giudici 2005, p.12.

governance structure of the Parmalat group was contravention with the principles dictated by the Milan Stock Exchange. Independent directors had no incentive whatsoever to perform their duties and provide an objective standpoint on the business, because they had been nominated thanks to personal ties with Mr Tanzi. Those directors had no expertise to cover that type of position and to dig into the group's intricate business; this made them acquiescent to Tanzi's decisions.<sup>362</sup> The audit committee and the remuneration committee's members were linked to the group's ownership and this hindered any effective mechanism of checks and balances.<sup>363</sup> Another reason for the lack of non-executives supervision can be found in the absence of derivative litigation in Italy<sup>364</sup>, since directors can only face lawsuits from bankruptcy receivers and that narrows the field of application for that remedy.<sup>365</sup>

Tanzi who had a high school diploma, covered the posts of both Chairman and CEO, and the CFO Fausto Tonna had similar qualifications.<sup>366</sup> This made the board dependent on advice provided by external consultants, like lawyers, accountants and investment bankers, who all played an important role in the frauds, since they masterminded the strategies that led to the financial collapse.<sup>367</sup> It is worth reiterating that the second tier board, a feature of European corporate governance, was never effective at Parmalat in its duties of monitoring audit and accounts. In 1975 a Company Law reform transferred the audit functions of listed companies to external auditors.<sup>368</sup> In 1998, another reform related to listed companies was enacted, limiting the statutory auditors' functions to two areas: firstly, the supervision of company's compliance with relevant laws and statutes; secondly, the monitoring of company's management, regard to standards of good management and to organisational and management structures.<sup>369</sup> In order to limit the board's complacency towards controlling

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Supra Dalcò and Galdabini 2004, ch.2; and Ferrarini and Giudici 2005, p.19.

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F. Benedetto and S. Di Castri "There is Something About Parmalat (On Directors and Gatekeepers)", *Banca Impresa e Società*, 5/2005 p.211.

364

<http://www.classactionitalia.com/>.

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Supra Ferrarini and Giudici 2005, p.20,21.

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Supra Dalcò and Galdabini 2004, ch.2.

367

This is evidence of a different type of governance failure, compared to that of Enron.

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Art. 2409-bis Civil Code.

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shareholders, the reform mandated that listed companies introduced clauses in the articles of association that enabled minority shareholders to appoint a statutory auditor if they represented a significant stake. At Parmalat, this rule was circumvented because the required threshold set in the articles of association was 3%, and it was not met.<sup>370</sup> It has been observed<sup>371</sup> that the Italian rules related to corporate governance are as strict as those provided under English and American Law. The Milan Stock Exchange issued corporate governance recommendations to which listed companies have to either comply or explain.

Substantive rules should not be regarded as the main issue of this corporate failure, but what marked a difference with the legal scenario of some common law jurisdictions is the role of enforcement.<sup>372</sup> Because of the absence of a real deterrent upon directors, both in terms of derivative litigation and class action, the governance issue falls back on gatekeepers. The involvement of market players like Grant Thornton, Deloitte, Citi Group and Bank of America in the actions brought by the Commissioner is a sign of the central role these professionals had, both for Parmalat and for investors.<sup>373</sup> The issues related to gatekeepers' role and their presumed incentive to monitor their clients and perform a service in the public interest have been examined in the previous section with regards to Enron.<sup>374</sup>

In 1998, the group faced the problem of having to choose new auditors, which at that time may have meant revealing to third parties the true picture of the company's status and the purpose of some of the transactions in place.<sup>375</sup> The solution came from two Grant Thornton's partners who suggested creating a new shield, the famous Bonlat, a subsidiary incorporated in the Cayman Islands, which could be certified by Grant Thornton, acting as second auditor. Bonlat started being used as a wastebasket, thanks to the cooperation of the primary audit firm, the newly appointed Deloitte.<sup>376</sup> As it has been acknowledged by the

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Art. 2403 (1) Civil Code.

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Supra Ferrarini and Giudici 2005, p.35.

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Ibid.

372

Ibid p.26-28.

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Ibid p.31,32.

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Supra Coffee 2002.

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Supra Ferrarini and Giudici 2005, p.27.

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CONSOB investigation<sup>377</sup>, Grant Thornton's controls were lacking and the audit firm had a reputation – thanks to its involvement in the Cirio scandal previously – for playing a central part in letting its clients pursue accounting irregularities. Although auditor's independence and exclusivity of their service are considered central in the new approach towards auditing functions within most jurisdictions, this concept has been thwarted by the peculiar way in which consulting firms organise their structure.<sup>378</sup> Deloitte had been investigated with regards to a transaction in which the Malta branch was involved in an inter-company loan between Bonlat and another subsidiary. Allegedly the investigation brought to light Deloitte's lax attitude towards the transaction and overall towards several similar operations.<sup>379</sup> It appears that firms auditing Parmalat were ineffective and acquiescent in their roles of watchdogs, since their prime concern was to acquire more profitable consultancy services.<sup>380</sup> Those among the auditors who raised red flags about information provided by Parmalat or because of transactions carried out, were removed or disregarded.<sup>381</sup> A substantial part of Parmalat's narrative is concerned with the analysis of certain practices and transactions conceived by management and external advisors to raise funds and to keep the group's accounts look healthy from the market's perspective. Whether the techniques adopted can be singled out as corporate finance is doubtful, since setting up fictitious transactions has little to do with finance.<sup>382</sup>

Parmalat started having financial problems well before its final bankruptcy. Resorting to the capital markets was the only way to keep the business running; this design, entailed the distortion of several financial tools and the adoption of aggressive and risky managerial practices. In the 1980s the group had to start adjusting its balance sheet in order to obtain a better rating when issuing bonds on the stock market; this was done by establishing a number of wholly-owned off-shore vehicles that were conceived as a tool to absorb group's

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Ibid, p.25.

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CONSOB decision no. 14671 28 July 2004.

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Supra Davies 2007.

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Bloomberg News, 16 March 2004, at [www.bloomberg.com](http://www.bloomberg.com).

380

Supra Ferrarini and Giudici 2005, p.29.

381

Ibid, p.26,27.

382

Supra Dalcò and Galdabini 2004, ch.1.

losses through fictitious asset sales.<sup>383</sup> It came to be known that through these strategies around €1.5 billion of non-existing assets were absorbed by various SPVs, up until 1998. Under the professional advice of Grant Thornton, Bonlat Financing was created as a further shell entity.<sup>384</sup> Transactions were recorded on Parmalat's accounts as liabilities for Bonlat and as assets for Parmalat. Since Bonlat was part of the group and its financial statement had to be included in the consolidated group account, Bonlat had to show some active entry in order to offset its debts to the parent company. This was achieved by the management in a way: by forging documents confirming the execution of fictitious transactions involving other companies within the group.<sup>385</sup> Through the scientific approach to cooking the books, coupled with a fake bank account created at Bank of America, Bonlat's non-existing, worthless assets were siphoned to \$7 billion by 2002.<sup>386</sup>

When Bonlat's accounts started to get out of hands, Parmalat management resorted to a new device, the Epicurum fund, set up under Grant Thornton's and Mr Zini's initiative.<sup>387</sup> The core function of this fund based in the Cayman Islands was to create the appearance of financial activities and to conceal the misappropriation of funds carried out by the Tanzi family. Parmalat's participation in the fund was itself fictitious since it resulted from the sale to Epicurum of €500 million of Bonlat's credits from Parmatour.<sup>388</sup> The obscurity of transactions related to this particular entity helped the authorities to discover the fraud, when in 2003 Deloitte announced that it had failed to certify Parmalat's financial statement due to the lack of information concerning the relationship between Parmalat and the Epicurum fund.<sup>389</sup>

Another subsidiary which raised concerns as to the genesis and scope of its operations was Buconero, an entity conceived by the Citigroup management who proposed to Parmalat a

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Storelli 2005, p.781; and Capolino et Al. 2004 p.289.

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Supra Capolino et Al. 2004, 290.

385

Ibid p.292.

386

Ibid p.294.

387

Supra Storelli 2005 p.785.

388

Supra Capolino et Al. 2004, p.200.

389

Supra Storelli 2005, p.787.

structured finance transaction centred around a subsidiary they incorporated in Delaware: Buconero LLC. This company remained under the direct control of Citigroup, despite being a financing vehicle for the Parmalat group.<sup>390</sup> Buconero entered into a joint venture with a Swiss subsidiary of the group, contributing €117 million to the partnership which the subsidiary intended to use to make inter-company loans to other entities within the group. Parmalat in fact recorded the amounts contributed by Buconero as equity, but Citibank had conceived the transaction as a way to give the bank a bond-like rate of return, while effectively shielding it from a loss on the investment.<sup>391</sup> While those amounts should have been recorded as debt instead of equity, this would not have served the usual purpose of overstating Parmalat's equity and understating its debt.<sup>392</sup>

If structured finance had become an over-complicated business at Enron, where obscure derivatives transactions were being carried out, at Parmalat the same goals were achieved through more simple and traditional means. Firstly, fictitious transactions were taking place. Parmalat reported that it had purchased and retired \$3.39 billion of its outstanding debt; that was achieved by forging bank documents stating that Bonlat repurchased \$3.39 billion of debt issued by another Parmalat's subsidiary. The debt remained outstanding was not mirrored in the financial statement that once again was giving a false image of the group's financial status.<sup>393</sup> Secondly, Parmalat resorted to the use of double billing in order to inflate assets and obtain liquidity. This scheme helped the group raising huge amounts of money since the fake invoices were being securitised and further liquidity obtained by banks.<sup>394</sup> Thirdly, a device employed to understate debt was to mischaracterise bank debts as inter-company debts, since the latter does not appear on consolidated financial statements, unlike debts owed to third parties.<sup>395</sup> It can be recognised that a multitude of techniques were employed in order to alter the financial statement of the group. If in the USA gatekeepers were in a way deceived by a market bubble, by the sophisticated employment of structured finance and by the excessive flexibility of accounting rules, their counterparts in Italy played

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Supra Capolino et Al. 2004, p.200.

391

D. Reilly and A. Galloni "Spilling Over: Top Banks Come Under Scrutiny For Role in Parmalat Scandal", Wall Street Journal, September 28 2004, A1.

392

Supra Storelli 2005, p.788.

393

First Amended Consolidated Class Action Complaint for Violation of the Federal Securities Laws, in Re Parmalat Securities Litigation, 375 F. Supp 2d 278 (S.D.N.Y. 2005).

394

Supra Storelli 2005, p.789 and p.790.

395

Supra Reilly and Galloni, 2004.

a more vital role in the scandal, since for a much longer time and to a higher degree they were contributing to hiding frauds and at the same time to their perpetration. This can serve as explanation as to the rationale of recent reforms, which in Italy have been concentrated around the role and position of gatekeepers rather than on accounting rules.<sup>396</sup>

Despite different ownership structures and antipodeans corporate cultures, the accounts of Enron and Parmalat showed surprising convergence. Even more striking is the extent to which both firms' financial strategies revolved around the abuse of debt capital market finance, and more around a complex web of structured transactions involving remote offshore entities which all in all contributed to the apparent success of the two corporations and to their collapse.<sup>397</sup> The persistence of similar corporate finance strategies, despite a rather divergent underlying financial environment in the US and Italy, is an element of concern and it justifies some of the criticisms towards the intrinsic dangers and instability of stock market finance. Shareholder sovereignty was pursued in both contexts and it inevitably led to the unrestrained application of takeovers as the ultimate means to achieve shareholder democracy and alleged control over management.<sup>398</sup>

Parmalat's rise as one of the largest Italian corporations was consequential to a wave of acquisitions that were backed by debt that the group was never able to recover because of the limited margin of profit of its core business.<sup>399</sup> Going public became for Parmalat a means to stay afloat by concealing a problematic financial status through accounting manipulations and by issuing bonds on the basis of inflated share value. The fraud was conceived as a way to survive, as a temporary solution in order to weather out financial difficulties.<sup>400</sup> Enron's rapid growth was driven by an innovative approach towards the energy business, helped to a great extent by the industry deregulation in the USA. The corporate finance strategies came to have the same prominent role they had at Parmalat because through off-balance sheet financing the management dumped bad assets into the archipelago of off-shore entities; this helped inflating the company's stock price and creating a more successful image through the lens of capital markets. It needs to be repeated that all this was exacerbated by perverse

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Supra Storelli 2005, p.806.

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R.H. Schmidt and M. Tyrell "Professional Forum. Financial Systems, Corporate Finance and Corporate Governance", *European Financial Management*, Vol.3, No. 3, 1997.

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M. Aglietta and A. Reberlioux "Corporate Governance Adrift. A Critique of Shareholder Value", *The Saint-Gobain Centre for Economic Studies Series* 2005, p.240.

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Supra Sapelli 2004, ch.3.

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Supra Storelli 2005, p.824. See A. Galloni "Scope of Parmalat's Problems Emerges", *Wall Street Journal*, January 27 2004.

governance mechanisms where distorted incentives in the shape of stock options played a central part in pushing top executives to pursue aggressive strategies.<sup>401</sup>

While regulatory responses were enacted in the US and in the EU as a reaction to the scandals, other areas of law escaped legislative correction. In hindsight though, some of the legal issues characterising Enron and Parmalat remained unanswered as they found a clear echo in the events that underscored the more recent global crisis. The abuse of debt capital market finance, clearly identified with the securitisation process and with CRAs' self-regulatory structure, has become *post* 2008 a more defined cause of modern financial scandals. The undisputed reliance on market forces led regulators *post*-Enron to leave the process of financial innovation unrestrained and largely unregulated. With regards to the specific role played by gatekeepers in the above scandals, legislation enacted after 2002 introduced more stringent rules for the regulation of the relationship between advisors and clients. What remained deficient was the statutory legitimisation that auditors lack in performing their functions. While auditors and rating agencies have come to perform an institutional and regulatory role, since they audit and rate their clients in the public interest, they lack a legal and democratic legitimisation for this role.<sup>402</sup>

Both scandals expose the limits and dangers of shareholder value. The accounts of the Enron and Parmalat scandals provided a dimension to the corporate governance and they provided a platform for a comparative examination of some of the main control issues. The two corporations epitomised different corporate cultures reflected in divergent corporate governance structures and arrangements. We are going to examine that the failure of some banks was due to the negligence of the management.

## **Barings Bank**

At the sudden collapse of a leading British investment bank stood a 28-year-old trader named Nicholas W. Leeson, a Briton who in the course of less than two years lost more than a £842 million and caused the bank to fail. Working in Singapore for Barings P.L.C., an investment house that had survived nearly two and a half centuries of ups and downs, Mr. Leeson eluded detection by his own firm and by outside regulators as he made an ever-mounting and ill-fated gamble on Japanese stock prices and interest rates.<sup>403</sup>

In London, the British Government ordered an urgent inquiry. In an interview with *The Financial Times*, Peter Baring, the firm's chairman, speculated that Barings could have been brought down by a deliberate act of criminal sabotage. But he said the bank did not know

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S. Bennett "The Real Reasons Enron Failed", *Journal of Applied Corporate Finance*, vol.18, issue 2, 2006.

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The framework designed in the US in the 1930s did not consider to whom this delicate function should have been entrusted. This institutional gap is perceived as an urgent issue to address.

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Share prices in Tokyo fell nearly 4 percent, but stock markets in most other financial centres were not hit as hard.



what had happened. Mr. Leeson, who had succeeded in the arcane business of derivatives despite having failed his high-school-level math exams, disappeared from his post in Singapore, just before the firm discovered the huge loss. He was reported to be in Kuala Lumpur. One - a bet that Japanese stock prices would rise - involved the purchase of futures contracts representing \$7 billion worth of shares. The other was a bet that interest rates would rise, and it took the form of contracts representing \$22 billion worth of Japanese government bonds and currency investments. There have been disputes within Barings in the short period about whether the Singapore operation was adequately supervised. Some officials questioned whether the Barings banking subsidiary, which oversees the derivatives business, had enough expertise to monitor the situation properly. Mr. Leeson had no reputation within Barings as a risk taker. Coming from a lower-middle-class family north of London, he had become quite successful since joining Barings three years earlier making big but ostensibly safe investments that sought to profit on the tiny differences between what identical financial instruments sold for in Japan and Singapore.<sup>404</sup>

Mr. Leeson changed tactics. Instead of matching buy and sell orders, he in effect became purely a buyer. Throughout the period Japanese stock prices were falling, creating losses that Mr. Leeson apparently tried to cover by increasing the size of his bet. Mr. Leeson's dealings, were primarily purchases of futures contracts on the Singapore exchange. They were less exotic than the complex derivatives cooked up by some banks and investment firms. Because the purchases required only a small down payment - 10 percent or less, traders said - Mr. Leeson was able to amass a position large enough to excite comment throughout Asian financial markets about his aggressive strategy, analysts said, even as his trading was going unnoticed by regulators. There are reports that Mr. Leeson used another complex strategy called a straddle, which amounted to a bet that the Japanese stock market index would stay essentially level. When regulators first tried to assess the extent of the damage, they calculated that of the \$650 million in losses they could identify at that point, \$500 million was attributable to the bet on stock prices, with the remainder from the interest-rate bet. If, as expected, Barings defaults on the contracts as they mature, the Singapore exchange and its clearing corporation was liable to pay the counterparties - the investors who made the opposite bet and stand to gain what Barings had lost. The Singapore exchange became a creditor of Barings, to be repaid based on how much Barings and its various parts bring when they were sold. As all of the contracts remained open and vulnerable to further losses from drops in Tokyo share prices or declines in interest rates. Perhaps it was the inherent lack of risk in such trading that prompted people to not be concerned about Leeson wearing multiple hats. Leeson took unauthorized speculative positions primarily in futures linked to the Nikkei 225 and Japanese government bonds (JGB) as well as options on the Nikkei. He hid his trading in an unused BSS error account, number 88888. Exactly why Leeson was speculating is unclear.<sup>405</sup> However, Leeson started actively trading in the 88888

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When his computer detected such a price difference, he would buy heavily in the lower-priced market and sell instantaneously in the other, generating small but steady earnings for the firm and substantial bonuses for himself.

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account as soon as he arrived in Singapore. He lost money from the beginning. Increasing his bets only made him lose more money.<sup>406</sup> A year later, this had mushroomed to GBP 23MM. By the end of 1994, Leeson's 88888 account had lost a total of GBP 208MM. Barings management remained blithely unaware. On February 23, 1995, Nick Leeson hopped on a plane to Kuala Lumpur leaving behind a GBP 827MM hole in the Barings balance sheet.

By February 1995, Leeson had accumulated an enormous position - half the open interest in the Nikkei future and 85% of the open interest in the JGB future. The market was aware of this and probably traded against him. Prior to 1995, he made consistently bad bets. The fact that he was so unlucky should not be too much of a surprise. Traders sometimes speculate without authorization. Leeson made headlines precisely because he was so unlucky. By the time he was discovered, he had bankrupted his employer. What is amazing about Leeson's activities is that he was able to accumulate such staggering losses without Barings' management noticing.<sup>407</sup> Leeson needed cash. By falsifying accounts and making various misrepresentations, he was able to secure funding from various companies within the Barings organization and from client accounts. His misrepresentations were flimsy at best. He claimed that he needed funds to make margin payments on behalf of BSS clients, and he gave a technical argument related to how the SIMEX collected margin as justification. This claim was false.

Despite his having to fund millions of GBP in losses, there were various factors that allowed Leeson to avoid discovery. There was a merger going on between two parts of the Barings organization. Barings had acquired stock brokerage Henderson Crosthwaite in 1984, which became BSL. BSL was run as a separate company from the banking business, which was called Baring Brothers and Company (BB&Co.). In November 1993, BSL was merged into BB&Co. in anticipation of a subsequent initiative to form a Barings Investment Bank (BIB). The merger was not easy because the two firms had different cultures. It was a distraction right in the middle of Leeson's tenure at BSL. Barings was starting to form a risk management function. Risk controllers were appointed in London, Tokyo and Hong Kong during 1994, but not in Singapore. In BSS, Leeson effectively controlled the front and back offices. There was no middle office. There was no single person within Barings responsible for supervising Leeson. As part of the 1993 reorganization, Barings had adopted a matrix approach to management of its offices. There was one reporting structure based upon products that cut across all offices. Another was based upon operations, ensuring local management of such items as systems, controls, settlement and accounting. Employees complained that lines of reporting were not always clear.

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He claims that he used the 88888 account to hide some embarrassing losses resulting from mistakes made by his traders.

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By the end of 1992, the 88888 account was under water by about GBP 2MM.

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As Leeson lost money, he had to pay those losses to SIMEX in the form of [margin](#) payments.

Leeson was involved with two products—futures arbitrage and trade execution for clients or other companies within the Barings organization. During 1994, his product line of reporting could arguably have been to either Ron Baker, who managed derivatives, or Mike Killian, head of Global Futures and Options Sales. Leeson could have reported to James Bax, who was head of the Singapore office, or to Simon Jones, who was Regional Operations Manager for South East Asia. Another issue was that Leeson was an accomplished liar.<sup>408</sup> Leeson was somewhat of a celebrity within Barings. While he was accumulating losses in account 88888, he was publicly recording profits in three arbitrage trading accounts, numbers 92000, 98007 and 98008. This was accomplished through cross-trades with account 88888. By performing futures transactions at off-market prices, Leeson was able to achieve profits in the arbitrage accounts while placing offsetting losses in the 88888 account.<sup>409</sup>

Peter Baring, Chairman of Barings, commented to Brian Quinn, Director of the Bank of England that: the recovery in profitability has been amazing following the reorganization, leaving Barings to conclude that it was not terribly difficult to make money in the securities markets. Six days after fleeing Singapore, Leeson was arrested in Frankfurt trying to make his way back to London. He was returned to Singapore to stand trial. Convicted of fraud, he was sentenced to six and a half years in Singapore's Changi prison. For good behavior, he was released from prison in July 1999.<sup>410</sup> Banks learned one lesson and forgot another. Barings' collapse showed that banks should be either small or big: there is no security in the middle ground. Proprietary trading is a game only for big banks that have deep pockets. When these banks take huge daily positions in foreign-exchange markets, they are gambling: they cannot know whether the price is going to rise or fall. The only people who benefit from the proprietary positions taken by the big banks are the staff and the shareholders, who receive bonuses and dividends. The customers whose interests are at risk receive no benefits at all.<sup>411</sup> This case appears that there was poor corporate governance and as a result the bank was collapsed.

ING, a Dutch bank, purchased Barings Bank in 1995 for the nominal sum of £1 and assumed all of Barings' liabilities, forming the subsidiary ING Barings. In 2001, ING sold the U.S.-based operations to ABN Amro for \$275 million, and folded the rest of ING Barings into its European banking division.<sup>412</sup>

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Leeson falsified records, fabricated letters and made up elaborate stories to deflect questions from management, auditors and even representatives of SIMEX. Leeson actively played on people's in securities.

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During 1994, Leeson booked £28.5 million in false profits.

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[http://www.riskglossary.com/link/barings\\_debacle.htm](http://www.riskglossary.com/link/barings_debacle.htm)

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Stephen Fay, *The Collapse of Barings*, (Richard Cohen Books, London, 1996) p296-297.

## Allfirst Bank

A former currency trader accused of hiding over £700m in losses at the Allfirst bank in the US pleaded guilty to one of the largest bank fraud cases in US history. Rusnak cooperated with the investigation. US Attorney Thomas DiBiagio said the investigation was continuing into the huge fraud scandal, but he said authorities had no other suspects. Rusnak was indicted in June in the biggest bank fraud case since Nick Leeson, a trader in Singapore for Barings Bank, lost millions on future trades, leading to Barings' 1995 collapse.

Rusnak allegedly ran up the losses at Allfirst Financial over five years, mostly from trading Japanese yen.<sup>413</sup> While trying to recoup those losses, he dug himself a deeper hole by taking ever-larger risks. Rusnak evaded detection by entering false information on the bank's books and records about his trading activity. He created fictitious trades that appeared to create assets to offset liabilities. Prosecutors said Rusnak did not directly profit from the trading losses, but by manipulating Allfirst's computerized system for tracking trading activities, they said he was able to generate a record appearing to show profits for the bank between 1997 and 2001. A judge will determine that based on a balance between the harm caused to the victims and Rusnak's ability to pay. Rusnak had faced a maximum sentence of 30 years in prison and a €1m fine. Leeson served 3 1/2 years of a 6 1/2-year sentence before his release from jail in 1998. AIB, based in Dublin, announced a proposal to sell Allfirst to New York State based M&T Bank Corp. AIB denied at the time that the currency trading scandal had anything to do with the sale. John Rusnak, an employee of AIB's Baltimore-based Allfirst Financial subsidiary dubbed Mr Middle America for his apparently average lifestyle, ran up huge trading losses over an 18 months period up to December in what the company called a complex, determined fraud done on the basis of conspiracy.

After allegedly going to ground, Mr Rusnak appeared at his home in an up market Baltimore suburb where he lived with his wife and two children. It was unclear whether Mr Rusnak and any accomplices had gained personally from rogue trading, or whether the massive losses were merely the result of incompetence. He allegedly bought foreign currencies that later fell in value and in a deception reminiscent of Nick Leeson, who brought down Barings - attempted to cover up the trades by setting up fictitious deals that appeared to offset the loss-making contracts. AIB said it would have been hard to violate its internal company controls in this way without collusion internally and externally, and has suspended five staff at Allfirst who were responsible for monitoring Mr Rusnak. The bank's annual profits reduced by 60 per cent to 596m euros (\$1.2b).<sup>414</sup> Analysts had mixed reactions to the news,

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Kapner, Suzanne (2001-01-31). "World business briefing: Europe; more restructuring by ING Group". New York Times.

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Angela Potter, (2002-06-13), Currency trader pleads innocent to fraudulently hiding \$691 M, The Middletown Press.

414

with some seeing it as a major black spot while others said AIB, because of its size, could absorb the loss. KBC Securities, saying AIB 2001 profit would be cut 60%, lowered its rating to reduce from accumulate. But SG Securities said the market had over-reacted in selling the share down, and maintained a buy recommendation. Deutsche Bank upgraded the stock to buy from market perform and set a target price of €12.9. Experts said banking controls would come under the spotlight. The industry had hoped it had closed the gaps laid bare by Barings's collapse.<sup>415</sup> AIB said Rusnak was part of a two-person foreign exchange trading operation at Allfirst that had annual revenue of less than \$10 million. It did not identify the other person, but said he had not been suspended. Allied Irish said it had halted foreign exchange trading at Allfirst and suspended several executives and confirmed that the deals had been in dollar/yen. Finance Director Gary Kennedy has said the bank had unwound the fraudulent positions and a bank spokesman confirmed that all the positions had been closed. This case appears that there was poor corporate governance and as a result the bank management showed very less supervision.

## BCCI

BCCI's unique criminal structure – an elaborate corporate spider-web with BCCI's founder, Agha Hassan Abedi and his assistant, Swaleh Naqvi, in the middle – was a component of its spectacular growth, and the cause of its eventual collapse.<sup>416</sup> There was no relationship more central to BCCI's existence from its inception than that between BCCI and Sheikh Zayed and the ruling family of Abu Dhabi. Abu Dhabi was present at BCCI's creation as one of two providers of BCCI's capital. It was BCCI's largest depositor, and its largest borrower, and for most of BCCI's existence, its largest shareholder. The relationship between the two entities was, as Price Waterhouse told the Bank of England days before BCCI's closure, with BCCI providing services to the ruling family of Abu Dhabi far beyond the ordinary relationship of a bank to either its shareholders or depositors. There are numerous examples of the centrality of the Abu Dhabi relationship to BCCI, and its unusual nature. In January, 1978, when BCCI decided to enter the United States and purchase shares in Financial General Bankshares, and needed two additional names, the ruling family of Abu Dhabi supplied them.<sup>417</sup>

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Shares in the company fell as much as 23 per cent in early trading but recovered ground as the City hardened in the view that the \$US750m was a one-off. They closed down 17 per cent, leaving the bank valued at £6.1b (\$20.6b). The FTSE 100 index fell to a seven-week low of 5,073.8.

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Leeson, sentenced to 6-1/2 years in jail, said the industry had failed to learn lessons.

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Senator John Kerry and Senator Hank Brown, The BCCI affair, (U.S. Government Printing Office, Washington, 1993) p1.

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In 1980 and 1981, when BCCI needed a purchaser for Bank of America's shares in BCCI, and had no one other than its bogus Grand Caymans bank-within-a-bank, ICIC, to buy them, Abu Dhabi stepped in to increase its interest in BCCI.

Throughout the 1970's and 1980's, the Abu Dhabi ruling family and the Abu Dhabi government placed billions of dollars in deposits at BCCI and its affiliates. In 1990, when accountants and regulators in the United Kingdom found fraud at BCCI, the Abu Dhabi ruling family and government stepped in again, agreeing to buy the bank, assert control, guarantee its losses, replace BCCI's head with the head of its own BCCI affiliate, the Bank of Credit and Commerce Emirates (BCCE), move BCCI's operations and records from London to Abu Dhabi, and work on a plan to find a way to save the bank despite its having acknowledged mishandling at least \$2.2 billion of Abu Dhabi's money. By July 5, 1991, when BCCI was closed globally, the Government of Abu Dhabi, its ruling family, and an investment company holding the assets of the ruling family, were the controlling, and official majority shareholders of BCCI owning 77 percent of the bank. But since the remaining 23 percent was held by nominees, Abu Dhabi was in fact BCCI's sole owner. After July 5, 1991, it was in Abu Dhabi that most of BCCI's top officials remained, where they remain under the control of the Abu Dhabi government, under conditions said to be luxurious, which the Abu Dhabi government refuses to discuss.

The Bank of Credit and Commerce International Plc (BCCI), an international bank with branches in over 70 countries, collapsed in July 1991.<sup>418</sup> The bank had been founded by Agha Hasan Abedi in 1972, and was managed until its failure by Agha Hasan and Swaleh Naqvi, an early associate.<sup>419</sup> The collapse was traced to a situation in which the executives started falsifying BCCI's accounts in order to hide the financial difficulty that was occurring within one of its customers, the Gulf Group. This led to a liquidity problem in the bank. There were allegations that BCCI became involved in money laundering activities on behalf of drug dealers in Columbia, resulting in the arrest of some officials of the bank in Florida, United States in October 1988.<sup>420</sup> The United Kingdom Prime Minister at the time commissioned Lord Justice Bingham to report on the events that led to the collapse and the report published in 1992 indicted the auditors, Price Waterhouse for creating an avenue for conflict of interest by acting as both auditors and consultants to BCCI. The Bingham Report criticised the Bank of England, for lacking in its supervisory role. The blame on the Bank of England was valid as it should have been obvious to anyone much earlier than 1991, when the Bank of England chose to wind down operations at the bank, that there were issues at BCCI which needed investigation, especially with the arrest of the BCCI officials in the United States in 1988. The behavior of the company directors was in issue as was evident from their actions. The UK Companies Act 1985 specified in its section 221 (1) that every company shall keep accounting records which disclose with reasonable accuracy the financial position of the company at any time. The directors at BCCI disobeyed this

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Wearing, R., *Cases in Corporate Governance* (London: Sage Publications 2005) p54

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Wearing, p55-56

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Wearing, p57-58

requirement. It is against established rules for a company to engage in money laundering<sup>421</sup>, and so the directors at BCCI who indulged in and approved this activity can be described as persons who lack integrity.<sup>422</sup> This case appears that there were no good corporate governance and as a result the bank was collapsed due to inadequate supervision.

The British government set up an independent inquiry, chaired by Lord Justice Bingham, in 1992. Its House of Commons Paper, Inquiry into the Supervision of the Bank of Credit and Commerce International, was published in October of that year. Following the report, BCCI liquidators Deloitte Touche filed suit against the Bank of England for £850m, claiming that the Bank was guilty of misfeasance in public office. The suit lasted 12 years. It ended in November 2005, when Deloitte withdrew its claims after England's High Court ruled that it was "no longer in the best interests of creditors" for the litigation to continue.<sup>423</sup> Deloitte eventually paid the Bank of England £73m for its legal costs.

## Lehman Brothers

The story of Lehman Brothers is a case in which disobedience of established rules and principles contributed to the company's failure. The Lehman Examiners' Report states that there are legitimate claims against the CEO, CFO and other officers who oversaw and certified misleading financial statements which in turn contributed to the demise of the company.<sup>424</sup> There was falsification of financial records and there were instances of the Lehman Brothers officers exhibiting inappropriate behavior, an example of which was terminating the employment of one of its staff who blew the whistle on certain accounting abuses. Section 401 of the Sarbanes-Oxley Act provides for disclosures relating to off balance sheet items, the Lehman Brothers directors flouted that rule and this was a contributory element to the failure. If the directors at Lehman Brothers had been persons who were prone to obeying rules, they would have abided by the provisions of the Sarbanes-Oxley Act, and this might have prevented some of the problems which ensued.<sup>425</sup> The act of

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Wearing, p57-58

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The collapse of BCCI created financial losses for a large number of individuals, employees, companies, local authorities, and countries.

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Gray, Joanna. "Court castigates BCCI liquidators' claim against Bank of England". *Journal of Financial Regulation and Compliance*. 14 (4): 411–417. doi:10.1108/13581980610711180. Tait, Nikki (2006-06-08). "Costs settlement brings to an end record-breaking BCCI litigation 12-Year action: [London 1st edition]". *Financial Times*. London (UK), United Kingdom. p.4. ISSN 0307-1766.

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The Lehman Examiners' Report, (note 131) Vol 1, 17 & 20. <http://lehmanreport.jenner.com/VOLUME%201.pdf>.

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The Lehman Report, (note 131) 3.

terminating the employment of a whistle blower is an indication of a situation in which the executives were involved in wrong doings and were taking steps to cover up their actions. The Lehman Examiners' Report analyses in the events that led to the failure and one of the significant issues raised is that Lehman's financial problems and the consequences to its creditors and shareholders were exacerbated by Lehman executives whose conduct ranged from serious but non-culpable errors of business judgment to actionable balance sheet manipulation.<sup>426</sup> The behavior of the directors was a major contributory factor to the Lehman Brothers failure. This corporate failure became the largest bankruptcy proceeding ever filed as at September 2008.<sup>427</sup> Even though Lehman Brothers took out insurance policies to indemnify the company and executives for liability and settlements arising from law suits, the economic and social losses accruing from the failure was enormous.<sup>428</sup>

While the roots of Lehman Brothers lie in a dry goods business founded by two German-born brothers in Alabama in 1844 who later moved into the banking sector, the emergence of the present-day investment bank can be traced back to 1990s when Richard Fuld was appointed president and CEO. Under his leadership Lehman started to push its business beyond traditional investment banking schemes, moving aggressively into the new patterns of financial markets and into the subprime securitisation market.<sup>429</sup> Fuld's managerial style came soon to prominence for his authoritarian manners as well as for the aggressive culture that was characterising at that time most rival investment banks and was aiming at closing the gap with the two main rivals and market leaders, Goldman Sachs and Morgan Stanley.<sup>430</sup> By mid 1990s Lehman had established itself as a leader in the market for mortgage-backed securities and, riding the wave of the US housing boom, it acquired five mortgage firms, among which BNC in California and Aurora Loan Services in Colorado, that contributed to generate record revenues in the capital markets amounting to a faster rate of growth than any other business in investment banking or assets management.<sup>431</sup> This steep growth was

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Ibid.

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The Lehman Report, (note 131) 2.

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The Article 'Fight for Lehman Insurance' in the Wall Street Journal, 10th September 2011 <http://online.wsj.com/article/SB10001424053111903285704576560692379898996.html>.

429

R. Swedberg "The Structure of Confidence and the Collapse of Lehman Brothers", Centre for the Study of Economy and Society, Cornell University, Working Paper series 51 2009, p.14.

430

H. Greenfield "Culture Crash, A Lehman Brothers Insider Reveals Why the Firm's Best Traits Turned out to be its Worst", 62 The Conference Board Review, Fall 2009, p.62.

431

Ibid.



propelled by the employment of new securitisation techniques, by CDO and CDS contracts, whose relatively poor understanding on the part of Fuld as regards relating risks and long-term consequences, proved critical for the firm. His lack of sophistication on new financial instruments and his background as a bond trader all explained certain reactions to market trends and to the way Lehman approached the market in the years preceding the crisis.<sup>432</sup>

Between 2005 and 2006 Lehman became the largest producer of securities based on subprime mortgages; in 2007, although cracks in the US housing market had become apparent, the firm's philosophy remained aggressive and based on anything to make the deal ethos that led Lehman to getting stuck in bonds and CDOs that could not pass on.<sup>433</sup> Lehman's new investments turned out to be as toxic as the older ones, creating more bad debts on the ailing company's books.<sup>434</sup> Lehman's position worsened in 2008, as its shares fell in response to the failure of two Bear Stearns hedge funds and to the near collapse of the bank itself. It has been suggested that the high level of leverage and the huge portfolio of mortgage securities made the investment bank vulnerable to market fluctuations. Investment banks were looked at suspiciously by some investors as a number of features of their capital structure were pointed out.<sup>435</sup> They had been using half of their revenue for compensations, which implied that employees maintained a strong incentive to increase the level of leverage and overall to pursue short-term strategies. As regards Lehman, it was observed that their leverage was 44:1, meaning that if the firm's assets fell by 1% that would imply a loss of almost half of Lehman's equity.<sup>436</sup> Lehman's assets were a matter of concern, especially as investors were trying to assess the value of the firm's exposures at the outset of the market collapse; the picture that came out was not one characterised by transparency, probably because responses in such direction would not have inspired market confidence.<sup>437</sup>

Fuld seemed to believe that Lehman could weather out any storms and while other firms were reporting heavy losses, Lehman was declaring profits of several hundred million

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Supra Swedberg 2009 p.15.

433

Ibid. This led to more than a dozen lawsuits initiated against Lehman by borrowers on the ground that the firm had improperly made them take on loans they could not afford.

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Ibid.

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D. Einhorn "Private Profits and Socialized Risks", Grant's Spring Investment Conference, 2009, available at [http://manualofideas.com/blog/2009/02/the\\_david\\_einhorn\\_page\\_greenli.html](http://manualofideas.com/blog/2009/02/the_david_einhorn_page_greenli.html).

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Supra Swedberg 2009, p.17.

437

Ibid.

dollars for the first quarter of 2008, with the rating agencies maintaining their full support for the bank's operations until its end. Rumours of the firm covering up its losses started to become stronger among investors and this proved to be determinant as the crisis grew deeper and fear mounted as to the real extent of the firm liabilities.<sup>438</sup> The way in which losses were concealed at Lehman deserves special annotation because of the transactions employed and the general support the bank received by various gatekeepers. It has been reported that \$49bn had been shifted off-balance sheet through a process called "repo105"<sup>439</sup>, a transaction designed to hide the bank's level of leverage and with little or no economic rationale.<sup>440</sup> Lehman's auditors Ernst & Young expressed confidence in the bank's accounts after the audit they conducted in 2007. It can be noted that their confidence was corroborated by a legal opinion provided by Linklaters, stating that "repo105" could be treated as sales under English law.<sup>441</sup> By using a legal opinion that was valid only with regards to English law, Lehman managed to keep billion of dollars of debt off its US balance sheet.<sup>442</sup>

As Secretary of the Treasury Henry Paulson emphasised Lehman's difficult economic position and the urgency to find a buyer, initial attempts to reach deals with Goldman Sachs, Bank of America and Morgan Stanley, came to nothing, despite the Federal Reserve having helped with a huge loan.<sup>443</sup> By the time Fannie Mae and Freddie Mac were nationalised with an infusion of around \$200bn by the Treasury, Fuld was desperate to raise capital in order to appeal potential buyers, but at that stage he failed to meet requirements set respectively by Korea Development Bank, Citigroup and JP Morgan Chase. A last throw of the dice was represented by Barclays' interest in taking over the Wall Street bank, but at that stage the

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Ibid.

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Repurchase agreements are exchanges in which a financial firm sells financial instruments to another financial firm at a discount to its market value, with a promise to buy it back at its full market value, a short time later. These deals have come to represent an important source of finance for short term purposes, and are considered safe because the investor/lender can take possession of the underlying asset in case of seller/borrower's default. These transactions is that, even though legal title of the underlying assets passes to the purchaser, their accounting treatment is that of financing transactions. Supra Blair 2010, p.16.

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J. Hughes "Fooled Again", Financial Times, March 19 2010; See Lehman Brothers Holding Inc. Proceeding Examiner's Report, Vol. III, March 11 2010, available at <http://lehmanreport.jenner.com>.

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Legal opinions are employed to corroborate the level of compliance within certain transactions and have the purpose of satisfying gatekeepers. In structured finance they satisfy agencies' requirements for the rating of securitised debts. See S.L. Schwarcz "The Limits of Lawyering: Legal Opinions in Structured Finance", 84 Texas Law Review, 2005.

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G. Wearden "Osborne blasts FSA over collapse of Lehman Brothers", [guardian.co.uk](http://guardian.co.uk), Monday, 15 March 2010.

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A.R. Sorkin "Too Big To Fail", Allen Lane 2009, p.306-307.

British counterpart was conditioning the offer upon a heavy US guarantee against Lehman's liabilities, and as it turned out, the US government made clear that it would not proceed to another bailout after Bear Stearns had previously benefited from such support.<sup>444</sup> When Lehman Brothers filed for chapter 11 in September 2008 the event became somewhat of a public outcry of the freefall collapse of the capitalist order, as hundreds of employees were filmed outside the New York office, leaving the premises with boxes full of their belongings. Responses around the world's main stock markets saw plunging indexes and the NYSE was hit by news, this time of Merrill Lynch collapse saved by a Bank of America buyout negotiated for \$50 bn.<sup>445</sup>

Paulson's decision to let Lehman Brothers go down proved to be a crucial one, perhaps justified by the critics he had received for having previously used public money to bailout Bear Stearns, Freddie Mac and Fannie Mae, and for not having let the market deal with the crisis as it had been suggested among most professional and academic circles in the States.<sup>446</sup> The idea that the market could police itself resulted fallacious as it became clear that the laissez-faire attitude promoted by the Bush administration in allowing a major financial institution to collapse created a catastrophic environment: nobody in the financial world trusted anybody's claims of solvency and the flow of money around the economy froze up.<sup>447</sup> It has been observed before the Committee on Oversight and Government Reform<sup>448</sup> that bad regulation, lack of transparency and market complacency were among the main causes that triggered the financial crisis and led to Lehman collapse. The deterioration of lending standards, it was argued, was exacerbated by the employment of securitisation on lower quality mortgages.

Checks that should have been performed by capital markets became problematic because of the nature of securities like CDOs; the picture was made muddier by the relationship between issuers and rating agencies because of the increasing market power of the former and the attitude endorsed by banks that started shopping for the best rating and for the

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A. Clark "How the collapse of Lehman Brothers pushed capitalism to the brink", guardian.co.uk, Friday 4 September 2009; and L. Elliott and J. Treanor "Lehman downfall triggered by mix-up between London and Washington", guardian.co.uk, Thursday 3 September 2009.

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Ibid.

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D. Wessel "Government's Trial and Error Helped Stem Financial Panic", Wall Street Journal, September 14 2009.

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Supra Clark 2009. The decision to let Lehman collapse was defined as a colossal failure of common sense by a former vice president, Larry McDonald, who summed up the firm as a scrappy overachieving investment bank that had lived in tranquil seas for too long lulled into the belief, from two decades of prosperity, that making money was easy.

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L. Zingales "Causes and Effects of the Lehman Brothers Bankruptcy", before the Committee on Oversight and Government Reform, United States House of Representatives, October 6 2008.

riskiest way to get a triple-A.<sup>449</sup> As regards Lehman, the high level of leverage and the strong reliance on short-term debt financing, coupled with the low level of collateral posted for CDS contracts brought about the premises for a systemic failure and uncertainty about the true value of the bank's equity.<sup>450</sup> As the ensuing bankruptcy forced the market to reassess the risks related to certain practices, the event had an enormous impact on the global financial system and it is identified as what kick started the economic crisis.<sup>451</sup> This case appears that there were no good corporate governance and as a result the bank was collapsed due to inadequate supervision. We are now going on to discuss Northern Rock as it also showed the bank poor corporate governance due to poor management.

## Northern Rock

Mr Applegarth joined Northern Rock as a graduate trainee in 1983. He rose within Northern Rock having been appointed head of planning in 1989, assistant general manager in 1992, executive director in 1996 and was made chief executive in 2001. He was the youngest ever FTSE 100 chief executive.<sup>452</sup> Mr Applegarth was renowned for being driven, he was seen as ambitious and the aggressive growth strategy at Northern Rock mirrored Mr Applegarth's personal approach. It has been reported that these bullish tactics resulted in the majority of the executives being intimidated by him,<sup>453</sup> evidenced by his necessity to have arrears reported at half the CML average. Although Mr Applegarth had spent twenty four years working at Northern Rock, when questioned by the Treasury Select Committee he by his own admission stated: I am not a qualified banker.<sup>454</sup> This was in answer to question 666 of the Select Committee evidence, and epitomises the dangerous nature of the Northern Rock Board make up, and their lack of banking experience. He quit as chief executive in 2007.<sup>455</sup> Dr Ridley was appointed to the Board in 2004.<sup>456</sup> At the Treasury Select Committee hearing Dr Ridley described himself as a businessman citing his participation on a number of

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Ibid.

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Ibid.

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G. Gordon "The Panic of 2007", NBER Working paper n. 14358, 2008.

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Northern Rock: So who is Adam Applegarth? This is Money (16 September 2007).

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Anthony Hilton, 'Demands of the city forced bps collapse' London Evening Standard (28 July 2010).

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1).

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Philip Aldrick and Katherine Griffiths, 'Rock chief and seven directors quit' Telegraph (17 November 2007).

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different Boards as evidence of his extensive experience,<sup>457</sup> however Dr Ridley had no previous banking experience prior to his appointment to the Board of Northern Rock.<sup>458</sup> Dr Ridley is a zoologist and it is difficult following his tenure as Chairman of Northern Rock to not observe a certain irony in his publication *The Rational Optimist: How Prosperity Evolves*.<sup>459</sup> His father Viscount Ridley was chairman from 1987 to 1992 and sat on the Board of Northern rock for 30 years. Following the financial scandal at Northern Rock Dr Ridley resigned as chairman in 2007.<sup>460</sup>

Sir Ian Gibson was a respected man, he began his directorship career in the Board of Nissan Motor Manufacturing in 1987. In 1999 he became the senior vice-president of Nissan Motor Company in Japan, and was knighted in the same year for his services to the motor industry. Sir Ian's experiences branched out further than just the motoring sector, during his career Sir Ian has been Chairman of BPB plc, was on the Court of the Bank of England, has been Chairman of Trinity Mirror, and was Deputy Chairman of Asda Group plc and a non-executive director of GKN plc and Greggs plc.<sup>461</sup> Sir Ian's extensive business experience spanning across a wide range of sectors made him an ideal candidate for the senior independent director. Sir Derek had experience within the financial sector. In 1967 he joined Westminster Bank, a constituent of the present NatWest Bank, rising to become NatWest's Director of Personal Banking from 1986-1988. He was appointed group chief executive in 1992. Sir Derek's experience within the sector led him to some pivotal roles, for example he is chairman of the Financial Services National Training Organisation<sup>462</sup> and in 2001 was appointed by Chancellor Gordon Brown to conduct a review of the long-term trends that might affect the health care service in the UK. He is a qualified Statistician and Banker and attended the Program for Management Development at Harvard.<sup>463</sup> Sir Derek resigned at the same time as Mr Adam Applegarth on the 16 November 2007.<sup>464</sup>

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1).

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ibid.

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ibid.

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Dr Matt Ridley, *The Rational Optimist: How Prosperity Evolves* (HarperCollins 2010).

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Treasury Committee, The Run on the Rock (n 3) 18.

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Sir Ian Gibsons Biography at <http://www.morrisons-corporate.com/About-us/Board-membersbiographies/>.

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'Profile: Derek Wanless' BBC News Channel (25 February 2014).

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HM Treasury, Biographical Information about Derek Wanless accessed at [http://webarchive.nationalarchives.gov.uk/+http://www.hmtreasury.gov.uk/consultations\\_and\\_legislation/wanless/](http://webarchive.nationalarchives.gov.uk/+http://www.hmtreasury.gov.uk/consultations_and_legislation/wanless/)

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It has been reported that following the demutualization of Northern Rock in 1997, the company led an extremely aggressive expansionist business model which by 2006 had allowed the bank to grow its assets from £15.8 Bn to £101 Bn.<sup>465</sup> It has been shown that the development of their business model resulted in 89.2% of its assets contained within securitised mortgages.<sup>466</sup> The intentions of the business model were to increase growth of the company and Northern Rock were confident in the quality of their business model,<sup>467</sup> however evidence has emerged that bring into the question the quality of the decisions made under the Northern Rock business model. Outside the bank, commentators remarked that the business strategy was one of many extremes.<sup>468</sup> A factor not lost on then Governor of the Bank of England, Mervyn King, who was quick to point out that the rapid growth strategy undertaken by Northern Rock resulted in the bank growing at a rate three times faster than any other bank at that time. Before the crisis hit the Chancellor of the Exchequer denounced the behaviour of Northern Rock, he noted that in 2007 Northern Rock undertook a strategy at odds with the market trends and had expanded its market share.<sup>469</sup> Sir John Gieve, Deputy Governor of the Bank of England, admitted that the Northern Rock business model made it more vulnerable than other banks.<sup>470</sup>

Combined with a fall in the share price, between January and September 2007,<sup>471</sup> this should have been a warning signal to the Board of directors to reconsider their expansionist policy. Mr Applegarth commented that the bank was expanding that it had been doing for many years but it is argued what whilst making this remark he failed to take into account the changing nature of the financial sector.<sup>472</sup> Following the demutualisation of the bank in 1997 the period had been one of prosperity. For a bank whose main line of business was wholesale mortgage lending it had benefited from the housing price increases of 2000's, but

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ibid.

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ibid.

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 388.

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 401.

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 749.

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ibid.

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Even prior to the troubles in August the share price had fallen from £12 in January 2007 to roughly £8 by the end of July. See Treasury Committee, The Run on the Rock (n 3) 23.

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 452.

it is argued that the change in the market that began in 2006 was one that should have altered the business model of a bank that was dependent on wholesale funding. The expansion continued into the 2007 where Northern Rock was running a business model that was taking 19% of the net lending. If this is to be compared to HBOS, who was one of the largest lenders in the market, during the same time captured 8% of net lending. The conclusion from the Treasury Select Committee outlined that they believed the directors pursued a reckless business model which was reliant on wholesale funding.<sup>473</sup> Whilst the governor of the Bank of England commented that the business strategy was fatally floored.<sup>474</sup> As a result of the poor decisions Northern Rock posted losses of £167.6 million in 2007.<sup>475</sup> As a result of the actions of the Board during the crisis the losses rose to £1.36 Billion in 2008.<sup>476</sup>

Each of these decisions can be seen to be breaching any one of the list of factors a director must have regard to under s.172 (1). Pursuing a growth strategy at odds with the rest of the market is going to have negative consequences in the long term.<sup>477</sup> Whilst this is the case the greatest problem with regards to accountability, is that the matters do not impose free standing duties, and as such the director needs to think about and to give proper consideration to those factors.<sup>478</sup> A director cannot be held liable if they do not consider a specific factor, even though Parliament considered Directors' consideration of them to be an integral part<sup>479</sup> of their duty to promote the success of the company. In 2010 evidence emerged that Mr David Baker and Mr Richard Barclay deceived shareholders by concealing 1,917 mortgages to borrowers. As a result, the then Financial Services Authority (FSA) fined David Baker £504,000 and Richard Barclay £140,000.<sup>480</sup> The FSA revealed that in 2006 Mr Baker became aware that the loans were omitted from mortgage arrears figures, which formed part of the management information and communications made to the market; Mr Baker knowingly did not escalate this information satisfactorily nor make any formal

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Treasury Committee, The Run on the Rock (n 3) 3.

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ibid.

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Northern Rock Annual Report 2007.

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Northern Rock Annual Report 2008.

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Companies Act 2006 s.172(1)(a).

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Margret Hodge, the Minister of State for Industry and the Regions; DTI, Duties of company directors: ministerial statements (June 2007) 9.

479

Davey Ka Chee-Wu, 'Managerial behaviour, company law, and the problem of enlightened shareholder value.' (2010) 31(2) Comp

480

FSA Communication Document: FSA fines and bans former Northern Rock deputy chief executive and credit director for

record that this issue had arisen. This was heightened by Mr David Jones for when he became aware of the situation in 2007 he agreed to continue to allow false mortgage arrears figures to appear in footnotes accompanying the 2006 annual accounts. As Margret Cole, FSA's director of enforcement of financial crime points out: 'David Jones had numerous opportunities to put things right, but failed to do so.'<sup>481</sup>

From 2005, staff members at Northern Rock were under pressure to ensure that they reported arrears and possession figures on loans at half the CML average.<sup>482</sup> Whilst balancing the aggressive growth strategy that was expected of them the DMU (Debt Management Unit), Mr Baker reduced the number of reported loans. If Baker and Jones had reported correct figures the FSA believed that Northern Rock's arrears would have increased by more than 50%, or repossessions figures by about 300%.<sup>483</sup> Professor William Buiter was critical of the aggressive expansion pointing out: the actions of directors can be perceived as a result of the extreme Northern Rock business model, set in place by Mr Adam Applegarth. In defence of the Northern Rock Board, expansionist policies were not limited solely to Northern Rock, as failures have shown, a number of institutions entered into difficulties pursuant to similar policies of rapid growth. The example of executive failure can be observed in the Royal Bank of Scotland following its acquisition of ABN Amro. There was no due diligence undertaken of ABN Amro in the six months prior to the deal being approved and received unanimous support of the RBS Board.<sup>484</sup> This transaction resulted in a £24.1 Bn loss in 2008, a point all more poignant to make given the bank would have been profitable and not entered into difficulties had it not acquired the Dutch Bank.<sup>485</sup>

A director must act in the way he considers, not what the court may consider,<sup>486</sup> in good faith, would be likely to promote the success of the company for the benefit of its members. It is the subjective standard of care that may be the greatest stumbling block to cultural reform. As has been highlighted in *Regentcrest plc v Cohen*<sup>487</sup> the decision the director

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FSA Press release, 'FSA bans and fines former Northern Rock finance director £320,000 for misreporting mortgage arrears figures' 27 July 2010.

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FSA, FSA Final Notice to Mr David Andrew Jones (27 July 2010) 4.2.

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ibid

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Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, (HC 2008-09, 519) 22.

485

Roman Tomasic and Folarin Akinbami, 'Towards a new corporate governance after the global financial crisis' (2011) ICCLR 237,

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This follows on from the case of *Re Smith & Fawcett Ltd* (n 88) 306.

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[2001] 2 BCLC 80.



makes need not be a reasonable one, so long as the director believed that they were acting in the best interests of the company, and that their belief was an honest one. It is clear that Mr Applegarth believed that his business model was prudent.<sup>488</sup> Whilst expressing regret Mr Applegarth said that it was a good business model but, it could not deal with the unforeseen global freezing of the liquid markets.<sup>489</sup> During questioning he mentioned that the failures of the bank were due to an unforeseeable global freeze. Under s.172 a director is expected to act for the benefit of the members as a whole. This means that a director is to act for the benefit of all members.<sup>490</sup> In the problems of enforceability of s.172, it would appear that the duty to promote the success of the company had little effect on the decision-making process of Adam Applegarth and the business model of Northern Rock. The role of the non-executive director as gatekeeper has been reminded the reader the duty of skill care and diligence is to be found under s.174 of the Companies Act 2006. Under the duty a director's actions are measured against the actions which would have been taken by a diligent person. The ability of the non-executive to hold the executive market participants to account is the role of the non-executive director and to monitor and supervise their conduct.<sup>491</sup> It is purported that it was the risk monitoring within Northern Rock that failed.<sup>492</sup> It is purported that a greater reliance on formal corporate governance structures would improve this by altering the general culture imposed within an institution. Whilst the culture begins with the CEO it has been identified that there is a core, irreducible requirement of directors to be involved in the management of the company and to take all reasonable steps to be in a position to guide and monitor.<sup>493</sup>

To investigate the liability of the directors, it is necessary to analyse whether any of them had any further skill, knowledge or experience that would raise the threshold of liability from the basic objective standard of a prudent director, to that where their skill would result in them falling under s.174(2)(b) of the Companies Act 2006. The Board of Northern Rock stated that the bank was hit by a liquidity squeeze that could not have been foreseen.<sup>494</sup> It is

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Treasury Committee, *The Run on the Rock* Volume II oral and written evidence (n 1) Q 423.

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*ibid.*

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Comments of Lord Goldsmith at HL Deb 6 February 2006 vol 678, col 256.

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Derrek Higgs, *Review of the Role and Effectiveness of Non-Executive Directors* (London: Department of Trade and Industry, 2003) para 6.6.

492

The de Larosi re Group, *The High Level Group on Financial Supervision in the EU* (European Commission, 25 February 2009) para 122.

493

*ASIC v Healey* [2011] FCA 717 para 17.

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imperative that any analysis must not be made through hindsight, there were specific and warnings given to the banks and Northern Rock prior to the run that should have made the non-executive directors question the business model that had been put before them at Board meetings. The indication that came from the authorities was in 2007 when the FSA released their financial risk outlook report stating if economic conditions were to deteriorate, this could lead to crowded exits, draining liquidity from the market and causing erratic price swings in commodities.<sup>495</sup> In 2007 the Bank of England released their financial stability report where they noted developments in the US sub-prime mortgage market have highlighted how credit risk assessment can be impaired in these markets and how participants can be hit by sharp reductions in market liquidity.<sup>496</sup> It is important to stress test and take those stress tests into account.<sup>497</sup> Further evidence to the fact was given by the Governor of the Bank of England, Mervyn King, who expressed warnings to the financial sector in 2007,<sup>498</sup> in his speech he remarked that liquidity of the markets in complex instruments is unpredictable.<sup>499</sup> Northern Rocks share price was as clear an indicator as any that problems were afoot. The share price was rapidly falling between January and July 2007, at a rate that was not the same as the industry trend.<sup>500</sup>

As the Higgs report notes a director should challenge and contribute to the development of strategy, and monitor financial controls and ensure systems of risk management are robust and defensible.<sup>501</sup> These signals should have led the directors to at least question the business model of the executives, and not simply be appeased by the executives. Whilst not questioning the business model Mr Gibson stated that he was aware of the risks of the business,<sup>502</sup> and under questioning in the Treasury Select Committee the directors argued to a

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 404.

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FSA, 'Financial Risk Outlook' (January 2007) 22.

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Bank of England, 'Financial Stability Report' (Vol 21, April 2007) 5.

497

Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 633.

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Speech by Mervyn King, Governor of the Bank of England at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House (June 2007) accessed at <http://www.bankofengland.co.uk/publications/speeches/2007/speech313.pdf>

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ibid.

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n1) Q 529.

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Higgs (n 88).

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 389.

point that of 2007 the directors began to see warning signs of the US sub-prime problems.<sup>503</sup> It was purported by the directors that there was a change in strategy to reduce the rate of growth of the company.<sup>504</sup> On the face of things this would appear to be a positive response by the Board, to reduce the rapid expansionist policies in light of dramatic market shifts; the reality of the situation is far different. By his own admission Mr Applegarth reported that following the implementation of the new business model the rate of growth would have been reduced to 16-17%.<sup>505</sup> That is correct, following warnings of a large shift in the financial market outlook, the company reduced its aggressive expansionist policy by a mere 2-3%, and it is difficult to see any slowing of growth at all. Through all of this, it appears the non-executive directors remained mute and positively approving a growth rate, which the committee members themselves remarked as being pretty aggressive compared to their dull businesses that some of them had been running in the past.<sup>506</sup> If these decisions are to be considered in the light of s.174 of the Companies Act 2006 both Sir Ian Gibson and Dr Riley owed a duty to the company to be an independent voice and to act as gatekeepers to the aggressive policies put forward by the executives. Since the issues of Northern Rock have unfolded a number of cases have been decided, for an example, the case of Lexi Holdings.<sup>507</sup> Although different on facts to Lexi Holdings the concepts are the same. Both Gibson and Riley owed a duty to monitor the risks posed to the business model and ensure good strategy, in not voicing a protest to the impending problems their inactivity it is argued would result in the breaching of their duty of skill care and diligence. The fact that they remained silent in the face of a dominating director such as Mr Applegarth meant that following Lexi Holdings Plc they would be in breach of their duty of skill, care and diligence under s.174(2)(a) in allowing ‘themselves to be dominated or bamboozled by one of their number.’<sup>508</sup>

Sir Derek was happy with the strategy taken by the Board and the operation with the risk committee itself.<sup>509</sup> It is argued that his previous experience in the financial sector should

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ibid Q 427.

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ibid Q 431.

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ibid Q 449.

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Ibid Q453

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Lexi Holdings Plc (in admin) v Luqman [2009] BCC 716.

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ibid.

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Treasury Committee, The Run on the Rock Volume II oral and written evidence (n 1) Q 437.

have led him to question the business model far more rigorously than he did. Sir Derek was brought in to the company following his work at NatWest, during his time at that company; in 1997 NatWest led an aggressive strategy into the US market. A £90 million loss was uncovered in its trading books and was overlooked by NatWest's review of its risk controls.<sup>510</sup> This is evidence of a director who had experience of aggressive expansionist business models, and expansionist business models that have not worked. It is argued that Sir Derek should have brought this experience to his role in the risk committee of Northern Rock. By his own admission, the strategy had been in place before he joined the Northern Rock Board in 2000,<sup>511</sup> and having taken up the position did not voice any concerns over such an aggressive strategy dismissing it as a growth strategy. Dr Ridley attempted to justify the capture of 19% of new lending in 2007 by remarking that we did not increase the rate of mortgage lending in the first half of 2007.<sup>512</sup> But it is argued that the markets had been changing and the bank had been informed on several occasions that markets were tightening. There may have not been any increased lending but there should have been steps to reduce the rate of growth with the changing financial environment. Sir Derek Wanless denied that this was an aggressive strategy, claiming that during 2007 Northern Rock had 10% of the market in new lending, but under questioning conceded that this was in fact 19% of new lending after repayments.<sup>513</sup> Sir Derek's experience in the financial sector should have led to him questioning the business model, applying his own knowledge of aggressive business strategies. The diversification of Northern Rock was a defence that was brought up repeatedly by the directors; the directors argued that diversifying into different business areas allowed them to continue on such a growth strategy whilst ensuring a suitable reduction in risk.<sup>514</sup>

Upon analysis it is clear that 75-80% of all of Northern Rock's business was in securitisation, if this is to be compared with other banks HBOS for example only holds 20% of business in securitisation. There is little diversification whatsoever, Sir Derek Wanless should have known this and, it is argued, failed in his duty of skill care and diligence under s.174(2)(b) as a result. There was pressure applied to executives to report pleasing figures to the chief executive, then following the cases of *Re Westmid Packing*,<sup>515</sup> *Lexi Holdings Plc*

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*ibid* Q 472.

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*ibid* Q473.

<sup>512</sup>

*ibid* Q 445.

<sup>513</sup>

*ibid* Q 465-471.

<sup>514</sup>

*ibid* Q463.

<sup>515</sup>

*Re Westmid Packing Services Ltd; Secretary of State for Trade and Industry v Griffiths* (No.3) [1998] BCC 836 at 842B.

and Weaving Capital (UK) Ltd (In Liquidation) v Peterson<sup>516</sup> it is the duty of the directors to be the independent voice and ask questions of the Board and the business model that was been implemented. It is argued that Dr Ridley and Sir Ian Gibson did not do this and their inactivity in the face of evidence that there may have been some problems with the business model adopted by the executives of the company resulted in the breach of their standard of care. The fact that they were appeased by Mr Applegarth is in itself a breach of duty by the remaining directors to allow themselves to be dominated or bamboozled by one of their number and it is argued that if the decisions were made today the influence of s.174(2)(a) of the Companies Act 2006 may alter the decision-making process of the directors. The fact that Sir Derek Wanless had financial experience meant that he should have applied that knowledge to his role as chair of both audit and risk committees. Whilst the directors failed to monitor and regulate the decision-making processes within Northern Rock. It is argued that following the financial crisis, and Lexi Holdings and Weaving Capital, the case law would force the directors of the company to pursue more rigorous questioning of the decisions of the executive director, and his aggressive business model. The remuneration structures of the Board, in an attempt to recognize whether a shift in remuneration culture may have been a contributing factor to the decisions made during the troubles. The thesis has demonstrated that there is a link between the structures of remuneration within a financial institution and the business decisions taken by that institutions senior management. Whilst remuneration structures need to attract and motivate individuals having characteristics necessary for success in the industry,<sup>517</sup> it is believed that shareholders must not allow directors to take unnecessary risks.

Northern Rock had a comprehensive remuneration structure prior to the financial crisis.<sup>518</sup> The 'Northern Rock Executive Directors Remuneration Package' consisted of a basic salary, an annual cash bonus, a deferred share scheme and a long term incentive plan.<sup>519</sup> The Remuneration Package structure encompassed both performance and non-performance related elements and offered an excellent balance to resolve the agency problems that permeate through from a misalignment of the interests of the directors and shareholders. It would appear that Northern Rock were following good governance guidelines. The Annual Reports confirmed that the Board recognized the need to ensure that performance related remuneration should align the interests of Executive Directors with those of the shareholders. The new remuneration structure was more favourable than the old structure. It

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[2012] EWHC 1480 (Ch) and the Court of Appeal judgment Weaving Capital (UK) Limited (in liquidation), Geoffrey Bouchier and Paul Clark (as joint liquidators (formerly joint administrators)) of Weaving Capital (UK) Limited v Charanpreet Dabha, Edward Platt [2013] EWCA Civ 71.

517

Walker Review, A review of corporate governance in UK banks and other financial industry entities: Final recommendations (26 November 2009) Section D.

518

Northern Rock Annual Report 2006, 18.

519

ibid.

is argued that this change in structure orchestrated a cultural shift within the bank towards more risky decision making with the hope to increase short term benefits for the directors.

The potential benefits to be accrued from 'The Short Term Bonus Scheme' increased to 200% of salary with half of any bonus earned deferred in shares for three years.<sup>520</sup> It was the new Share Matching Plan that was most controversial. The Share Matching Plan replaced the previous Deferred Share Scheme. Under the previous scheme if the company grew by at least 3% p.a, then the company would match the scheme at a ratio of 1:1. The new plan allowed executives to voluntarily invest in shares up to the value of their after tax cash bonus with an award of Matching Shares at a 2:1 ratio, if the company achieved real EPS growth of 15% p.a. This gave an incentive to directors to continue in pursuit of their aggressive growth strategy. It was in their interests to ensure growth remained above 15%, even at the detriment of the viability of the company. It is fascinating to note that a number of institutional shareholders had voiced their concerns of the remuneration structures even prior to the financial crisis. Hermes, were one of the first institutional shareholders to raise questions about the Northern Rock business model, its remuneration and accounting disclosure.<sup>521</sup> David Pitt-Watson noted what he believed to be 'Perverse incentives' at work at Northern Rock. Mr Peter Montagnon stated that the Association of British Insurers perceived the bonus policy to be too generous<sup>522</sup> and had brought their reservations to the attention of the Board.<sup>523</sup>

The problems arose from difficulties banks faced over the summer of 2007 in raising funds in the money market. The bank's assets were sufficient to cover its liabilities, but it had a liquidity problem because institutional lenders became nervous about lending to mortgage banks following the US sub-prime crisis. With shares in Northern Rock plummeting by nearly a third, the British Government moved to reassure investors with the bank, with account holders urged not to worry about the bank going bust. Northern Rock is not the only British bank to have called on the Bank of England for funds since the sub-prime crisis began but is the only one to have had emergency financial support from the Tripartite Authority (The Bank of England, the FSA and HM Treasury). However, the bank was more vulnerable to a credit crunch as its high-risk business model depends on funding from the wholesale credit markets, 75% of its funds coming from this source. In his address to the Treasury Select Committee, Bank of England governor Mervyn King had stated emergency funds would be made available to any British bank that needed it, but at a penalty rate, to

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ibid

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Treasury Committee, The run on the Rock Volume II oral and written evidence (n 1) Ev 336.

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ibid

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ibid.

ensure that lenders who had made bad lending decisions would suffer relative to lenders who had made sensible lending decisions.<sup>524</sup>

In August 2007, the funding markets froze, causing a liquidity squeeze. Northern Rock had conversations with the Bank of England to put a support facility in place if it needed it. The governor of the Bank of England pointed out that the funding strategy was flawed and professor Buiter described it as reckless. The Treasury Select Committee concluded that the directors of Northern Rock were the authors of the difficulties that the company faced and that it is right that they had been replaced. The Committee concluded that the board had provided information about its strategy, including that of funding, to its shareholders. Northern Rock collapse caused by the Bank of England refusing to help or to support its purchase by Virgin. On 17 September 2007, the UK government announced its guarantee for all depositors to halt the run on the bank. On 20 September 2007, this was specified to cover all deposits in existence with the bank on 19 September 2007. Northern Rock was nationalised on 11 January 2008.

## **Lloyds and HBoS**

The failure of HBoS, published by the Parliamentary Commission on Banking Standards in March 2013, highlighted some failings.<sup>525</sup> On 19 November 2015, the PRA and the FCA published two reports into the failure of HBoS: one that examines the failure itself,<sup>526</sup> and one that examines the enforcement actions taken by the regulator.<sup>527</sup> There is the failing of internal control. The senior management of the bank had given a large amount of independence to the divisions Corporate, Institutional and Treasury. These divisions that would go on to amass the enormous losses as individuals leading these divisions would underestimate the risk they were running. The failing was on the regulators. The FSA had noted a lack of internal control and an overreliance on funding through the wholesale markets, it did not follow through on this. The FSA was concerned with the implementation of Basel II.

HBoS was rescued by Lloyds and this is put forward as the reason as to why Lloyds required government assistance.<sup>528</sup> There are perspectives to consider in the rescue. The first is that

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<http://www.bankofengland.co.uk/publications/other/monetary/treasurycommittee/other/paper070912.pdf>

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Parliamentary Commission on Banking Standards, 'An Accident Waiting to Happen: the Failure of HBoS' (March 2013)  
<<http://www.publications.parliament.uk/pa/jt201213/jtselect/jtpebs/144/144.pdf>>

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Financial Conduct Authority and Prudential Regulation Authority, 'The Failure of HBOS Plc (HBOS)' (18 November 2015)  
<<http://www.bankofengland.co.uk/pr/Documents/publications/reports/hbos.pdf>>

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Andrew Green QC, James Segal and Simon Pritchard, 'Report into the FSA's enforcement actions following the failure of HBOS'

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of HBoS, which benefitted. It rescued the firm in providing security for customers, funding and employment for most of its staff. From Lloyds' perspective, the question is whether it would generate benefit when weighted against a negative impact on its financial position. Relevance is the limited due diligence carried out on behalf of Lloyds, which caused the board to make the decision based on insufficient information. Given how events unfolded, the board had reached the wrong conclusions. There is the perspective from the government. The merger is presented as a shotgun marriage, the Chancellor and Governor of the Bank of England maintained that their contribution was to place competition concerns to one side. Their support was clear and, together with the haste required at that point in time, the poor due diligence by Lloyds can be explained. It does constitute a failure of corporate governance at Lloyds to have pursued the deal.

## **The Royal Bank of Scotland**

The Royal Bank of Scotland was founded in 1727. With the acquisition of NatWest in 2000, it became the second largest banking group in the UK. It was the successful integration of NatWest during which Fred Goodwin made a name for himself, resulting in his promotion to CEO in 2001. The acquisition of NatWest included the NatWest Markets division, its investment banking arm. In the UK, RBS acquired Churchill Insurance and Direct Line. By 2007, RBS had become the global financial conglomerates. But when ABN Amro, a Dutch lender, under pressure from hedge fund TCI, sought to merge with Barclays Bank, RBS launched a hostile bid. It did so in May 2007 together with Santander and Fortis. The plan was to break ABN Amro into three parts: RBS would acquire its operations, including the Chicago based LaSalle Bank, whilst Santander would acquire the Latin-America based operations and Fortis its Netherlands based operations. ABN Amro unsuccessfully sought to defend itself by selling the crown jewels, in this case LaSalle Bank, to Bank of America for \$21 billion. By October 2007, with the global financial crisis commencing and Northern Rock receiving government support, the Barclays share-based bid lost in value to €61 billion whilst the consortium's cash bid remained steady at €71 billion.

RBS had to take the whole of ABN Amro's balance sheet with its own until it was split between the consortium members. It turned out that ABN Amro was exposed to the US mortgage crisis. RBS was exposed to severe combined losses from the mortgage positions of ABN Amro and RBS, whilst it was low on cash following the takeover. RBS had to ask investors for £12 billion in capital in April 2008. This was followed by a reporting of losses in August 2008. The UK government had to come to the rescue of RBS. The RBS had not actually breached any rules when taking over ABN Amro, not only board and general meeting had approved, in addition, huge cash reserves in the bank at the time, see also Adair Turner's report. On 29 November 2008 the government took a 58% stake in RBS worth £15

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House of Commons Treasury Committee, 'Banking Crisis: Dealing with the Failure of UK Banks' (May 2009)  
<<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/416/416.pdf>>



billion. Fred Goodwin was forced out. On 19 January 2009, the Blue Monday Crash, happened at once. RBS released a trading statement in which it announced that it expected to report trading losses of around £7 billion and write downs, in relation to the takeover, of around £20 billion. The UK government announced that it would inject funds into the UK banking system to guarantee bank loans to stimulate the UK economy. The government announced that it would increase its stake in RBS to 70%. The RBS share price collapsed by 67%, dragging other UK banks with it. On 16 Feb 2009, RBS reported a loss of £24.1 billion for 2008.

## **The Failure**

The failure of RBS was one of the failures of a UK bank during the financial crisis. It was led by Sir Fred Goodwin.<sup>529</sup> At the height of the crisis, RBS was involved in the takeover of ABN Amro, together with the Belgian Bank Fortis and the Spanish Bank Santander. It was in competition with old Barclays bank which had tabled an offer to merge with ABN Amro. In October 2008, it survived through the financial support of the UK government. The support was provided of both liquidity and solvency support. RBS' and Fred Goodwin's reputation were in tatters, becoming national symbols of what went wrong with the City. The FSA conducted an extensive analysis, which forms the basis for this case study.<sup>530</sup> The report can be split into the reasons for RBS's failure, lessons for regulators, supervisors and management, and FSA enforcement.

The report finds some factors that caused RBS to fail. The first factor was that RBS's capital position was far weaker than its published regulatory capital suggested due to poor definitions of regulatory capital. At the end of 2007, RBS had a capital position of £68 billion which meant that it had a capital ratio of 11.2% against the required 8% by Basel I and Basel II Pillar 1; likewise, its published Tier 1 capital ratio stood at 7.3% against a required 4%. These ratios were low compared to its UK peers: RBS pursued, in the words of Sir Fred Goodwin, a policy of capital efficiency. Despite these good ratios, RBS did not have enough capital to convince the markets that it could manage its future losses. RBS had worsened its capital position by a large debt-finance of the ABN Amro takeover, reducing its Tier 1 capital ratio to below its own target of 5.25%. The capital regime as prescribed by Basel II proved to be inadequate. This is being addressed by the introduction of Basel III. One of the improvements is that the Tier 1 capital ratio for important banks, such as RBS, is increased to 9.5%. The FSA calculated that, applying the risk weightings and methodology of Basel III,

RBS would have held a Tier 1 capital ratio of only 1.97% at the end of 2007. The other reason was due to the deficient way in which the required capital for trading books was

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As the events take place at the time that Fred Goodwin held a knighthood, he is referred to as Sir Fred Goodwin. He had his knighthood taken away at a later stage, well after the nationalisation of the Royal Bank of Scotland.

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Financial Services Authority, 'The Failure of the Royal Bank of Scotland' (December 2011)  
<<http://www.fsa.gov.uk/pubs/other/rbs.pdf>>

calculated. Following the Value-at-Risk based approach combined with the low risk weighting attached to the trading book, as prescribed by the regulators, RBS had only £2.3 billion of core Tier 1 capital available to cover all the losses from its £430 billion assets on the combined RBS and ABN Amro trading books. The Credit Trading area lost over £12 billion in 2008. RBS was dependent upon short-term wholesale funding. This was common for banks, but the situation at RBS was excessive. UK banks' loan books were growing much faster than their deposits: the combined funding gap for UK banks stood at £500 billion at the end of 2006. Although RBS had a capital problem as outlined, it was the liquidity problems that were the driver behind the failure. Other banks, financial institutions and other wholesale money market providers were unwilling to meet RBS's funding requirements.

The other factor was uncertainty and concern about future losses in view of the aggressive growth strategy that RBS had pursued.<sup>531</sup> This was not restricted to the losses from their credit trading operation but also from the losses from loan impairments. An economic recession was due to follow on from the crisis gave rise to great uncertainty about future loan loss provisions at all banks. The market anticipated that RBS's loan portfolio was of low quality due to its aggressive growth strategy and its willingness to take on risk, all of which was confirmed when RBS had to create large provisions for loan losses. From 2008 to 2010, RBS had to make impairment losses of around £30 billion. Another factor was the losses in credit trading of around £12 billion, which eroded the capital position and caused uncertainty about the losses.<sup>532</sup> In 2006, RBS had decided to grow its structured credit business aggressively. This included increasing its exposure to monoline bond insurers and leverage finance. By 2007, it was becoming clear that the underlying credits for these complex products were turning bad, RBS was slow to react, believing in the high ratings of the trades on their books. Once RBS tried to offload their toxic positions, it found that its distribution capability to sell positions that were turning sour to uninformed and uneducated clients was far less than that of other banks. It was stuck with its positions, leaving only the questions whether it was better to close the positions and take a loss, whether hedges would be available and what the best estimate of the losses at any date would be. In 2008, RBS realised trading book losses of £8.5 billion.

The take-over of ABN Amro, which exposed RBS to a greater number of risky assets, increased liquidity risk and eroded its capital base.<sup>533</sup> The takeover by the consortium of ABN Amro cost €71 billion, only €27 billion was to be paid by RBS for the parts that it wanted. These parts included LaSalle, which had been sold to Bank of America before the takeover, reducing the amount that RBS had to pay to only €16 billion: a number far smaller

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than the headline figures suggested and much smaller than its £23 billion acquisition of NatWest in 2000. The credit trading losses made by ABN Amro contributed greatly to RBS's total losses, increasing the market uncertainty about RBS's position. The acquisition was financed by short term debt: over €12 billion was financed by debt of a maturity of less than a year. Funding restraints arose as the cash from the LaSalle transaction remained stuck in the Netherlands whilst RBS needed to quadruple its funding commitments as it was committed to funding ABN Amro's inherited ABCP conduits totalling around £8 billion at the end of 2008. As RBS was the consortium leader, it needed to consolidate the whole of ABN Amro on its 2007 accounts, before distributing it amongst the other consortium members. This created uncertainty and a lack of transparency on where the losses would go, especially as Fortis, failed in October 2008. The increased fear in the financial markets for systemic risk, which hit banks with vulnerable liquidity, low asset quality and low capital ratios, such as RBS. Regulators and policy makers had failed to appreciate the element of systemic risk in the banking system. It caused a deterioration of market confidence which culminated with the failure of Lehman Brothers in September 2008. In the weeks after the collapse of this household name, there were banking failures and the markets were so nervous that nobody was prepared to meet RBS's funding needs. It had to rely on the emergency liquidity assistance provided by the Bank of England.

Next to these reasons that led to the failure of RBS, the FSA report examined the impact of the management, governance and culture at RBS on its failure. RBS had to deal with the same bad market conditions as other banks, there had been decisions made by its management that had left it in a more vulnerable position than other banks. The context in which the FSA has reviewed RBS's management is to satisfy a public interest in understanding the causes of RBS's failure. The FSA identified some areas of management, governance and culture for closer scrutiny. The first area is the effectiveness of board oversight and challenge. The examination is hindered by practicalities. It is not difficult to check that the process was appropriate by reviewing minutes of board meetings.

Another aspect is the board's role in relation to the ABN Amro take-over. The conclusion was drawn by the new chairman, who stated that the key decision that led RBS to its difficulties was the acquisition of ABN Amro. Such a take-over is the responsibility of the board and this was a risky take-over. As RBS was the leader of the take-over consortium, ABN Amro would be consolidated on its balance sheets before assets were transferred to the consortium partners. Records show that there was a significant number of meetings between board members leading up to the take-over, suggesting that the formal process has been adequate. It is undeniable that the decision making had been poor: despite adequate formal processes, the effectiveness of the board has to be questioned. The FSA identifies several reasons for such poor decision making, including an over-reliance on the past success from the NatWest take-over, the acceptance of poor due diligence in case of a hostile take-over, and the failure to appreciate the importance of customer and counterparty confidence in the bank.

There is the question whether or not, in his delegation of responsibilities to the management of the investment bank, he had maintained sufficient overview and understanding of the

actual business. It should be noted that the head of the investment banking arm, Johnny Cameron, settled with the FSA after an investigation and agreed that he would not take up any function or fulltime employment in the financial services industry in future.<sup>534</sup> The FSA would not take any disciplinary action.<sup>535</sup> To illustrate the lack of understanding with Johnny Cameron of the transactions his department was involved in, the FSA notes that he explained his knowledge of around May 2007 regarding CDOs to be as ‘I don’t think, even at that point, I fully, I had enough information’. Brian<sup>536</sup> may have thought ‘I understood more than I did’. It is around this time that ‘I became clearer on what CDOs were, but it’s probably later’.<sup>537</sup> It is obvious that senior management at the investment banking arm had little knowledge of at least some of the areas that they were active in, let alone had a thorough grasp of the risks associated with it. The board and the CEO should have held the investment bank on a tighter leash. The last aspect is the quality of risk controls and management information. The FSA notes several severe deficiencies. The board received a monthly risk report that was backward looking instead of forward looking. The Group Risk Officer was not invited to attend important meetings, including the regular morning meetings held by the CEO and his team. To summarise, the point of these deeper reasons reviewed in this section expose problems with management, culture and governance at RBS at the time of the crisis.

## Failures of Bankers

Since the height of the financial crisis passed, many cases have been reported in the media with regard to the behaviour or conduct of bankers. Several of the UK banks were implicated. Examples include mis-selling of payment protection insurance, anti-money laundering violations and rigging of the LIBOR rates and exchange rates. The majority of these cases of bankers’ misconduct either predate or happened during the financial crisis. A close examination may not assist in answering the research question. What does deserve a discussion is how it demonstrates a breakdown of corporate governance by a disregard from UK banks’ employees towards its customers, regulators and other stakeholders and, a complete breakdown in trust from the stakeholders towards the bank itself. This is an argument that follows the thread set out previously. It affirms the findings of the previous case studies that there was a lack of understanding and a lack of information flow, that controls were lacking and that challenges between senior management and other employees were absent.

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Financial Services Authority, ‘FSA Statement on Johnny Cameron’ (18 May 2010)  
<<http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/081.shtml>>

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Johnny Cameron now works part-time for a boutique investment bank.

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Brian Crowe, a senior manager at the investment banking arm of RBS

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## Mis-sold Products

Payment protection insurance (“PPI”) is an insurance for the borrower that insures repayment of their loan in case the borrower is no longer able to make repayments due to illness, loss of job and death. Due to the way that PPI works, the banks would get the premium of the insurance for the running of the loan and the benefit of the pay-out in case of repayment problems. Banks would make little to no profit on the underlying loan, but only on the insurance premium paid to them. It transpired that UK banks sold PPI to customers as part of their loans or credit card deals. Many customers were either unaware of the fact that they had bought protection or that they were not aware of eligibility criteria for potential insurance pay-outs. UK banks are paying compensation for mis-selling. As October 2014, RBS set aside another £100 million<sup>538</sup>, Barclays another £170 million<sup>539</sup> and Lloyds another £900 million.<sup>540</sup>

Another product that was mis-sold on a large scale were interest rate swaps.<sup>541</sup> These products exchange a fixed swap rate for a floating interest rate. By entering into such a product, a client may hedge its uncertain future floating interest rate payments for fixed ones. Depending on whether rates move up or down, the client may make a profit or loss by the transaction, but the point is that he has taken away his uncertainty about the level of future payments. These products have been sold to small businesses on a large scale as part of fixed rate loans. The Treasury Select Committee described the situation as ‘there is nothing wrong with selling a business a fixed rate loan, where the bank adds a hedge and fails to tell the customer I regard that, at best as mis-selling and at worst, immoral’. The conduct and behaviour of banks towards customers, their stakeholders, has been poor. It affirms the observation that regard for all stakeholders is a weak element of corporate governance at UK banks.

As a consequence of the increase in complexity in financial markets and products, misselling does not only happen to consumers but also to professional counterparties. The increased complexity in financial products has led to these type of problems is nothing new.<sup>542</sup> It is illustrated in litigation between Ceylon Petroleum Corporation (“CPC”) and its banks, brought both in arbitration and before the courts in England. CPC, the national oil and gas

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BBC, ‘RBS reserves £400m for currency probe’ (31 October 2014) <<http://www.bbc.co.uk/news/business-29839343>>

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BBC, ‘Barclays sets aside £500m in currency probe’ (30 October 2014) <<http://www.bbc.co.uk/news/business-29829112>>

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BBC, ‘Lloyds Bank confirms 9,000 job losses and branch closures’ (28 October 2014) <<http://www.bbc.co.uk/news/business-29798532>>

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BBC, ‘Banks face new mis-selling scandal’ (3 July 2014) <<http://www.bbc.co.uk/news/business28037608>>

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Bankers Trust International plc v PT Dharmala Sakti Sehajtera [1996] CLC 518

company of Sri Lanka, set up as a state enterprise and a body corporate, argued that it did not have the capacity to enter into a certain combination of options on oil on which it made substantial losses. Both Standard Chartered Bank (“SCB”) and Citigroup had sold protection to CPC against raising oil prices in the form of call options. The dispute with Citigroup resulted in arbitration, whilst that with SCB was fought in the English courts. The trust of CPC’s argument, which was accepted in arbitration but rejected by the Court of Appeal,<sup>543</sup> was that it was a transaction of speculative nature, rather than one of insurance, and that CPC as a state enterprise did not have the capacity to enter into such a transaction.

## **Money Laundering**

Banks are involved in large financial transactions and large international flows of money. Criminal organisations and others seek to abuse the international financial system and banks to launder money or for other illegal financial activities. Banks have strict compliance and anti-money laundering checks and procedures in place. Several UK banks have been accused of violating anti-money laundering regulations.<sup>544</sup> In December 2012, HSBC settled with the US regulators for a fine of £1.2 billion for allegedly circumventing restrictions on dealing with Iran and North Korea. A similar settlement of \$300 million had been reached between US authorities and UK bank Standard Chartered. It involves two UK banks that so far had not required a bail-out and had escaped much of the publicity in other scandals. Even in these cases, there appears to have been weak internal controls, reporting and oversight. It suggests that there were weaknesses in corporate governance.

## **Market Manipulation**

The LIBOR rate, or the London Inter-Bank Offer Rate, is a benchmark interest rate that is determined daily by averaging a number of submissions, the LIBOR submissions, by traders at various large banks. The LIBOR rate determines the value of many financial products, ranging from saving accounts and mortgages to complex derivative products. There are international equivalents, such as US LIBOR in the US and EURIBOR for the Eurozone. There is evidence that as 2005, traders at Barclays, sought to influence various LIBOR rates from their regional hubs.<sup>545</sup> It was investigated by the FSA, which concluded that there had been 257 requests to fix LIBOR rates between January 2005 and June 2009.<sup>546</sup>

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Standard Chartered Bank v Ceylon Petroleum Company [2012] EWCA Civ 1049

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BBC, ‘HSBC to pay \$1.9 billion in US money laundering penalties’ (11 December 2012), <<http://www.bbc.co.uk/news/business-20673466>>

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BBC, ‘Timeline: LIBOR fixing scandal’ (6 February 2013) <<http://www.bbc.co.uk/news/business18671255>>

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Financial Services Authority, ‘Final Notice to Barclays’ (27 June 2012) <<http://www.fsa.gov.uk/static/pubs/final/barclays-jun12.pdf>>

For Barclays, the first UK bank to be punished, the combined fines by various regulators amounted to £290 million. Its CEO, Bob Diamond, who had become the centre of media attention as the stereo-typical American style investment banker and the best paid CEO at a UK bank, refused to go. He was forced out by the Bank of England, who demanded a cultural change. Barclays' chairman and COO left at the same time. Other banks involved include the Swiss bank UBS, which was fined £940 million. RBS was fined a total of £390 million and the head of its investment bank, John Hourican, resigned.<sup>547</sup> Regulators have fined several banks over their traders' attempts to manipulate foreign exchange trades between January 2008 and October 2013.<sup>548</sup> These include the UK banks HSBC and RBS as well as UBS and US banks JP Morgan, City Bank and Bank of America. The fine amounts to £2.6 billion dollars, which was reached through a general settlement. Investigations at other banks, including Barclays, continues. As for the LIBOR scandal, individual traders were prosecuted and lost their jobs. It was confined to a handful of traders and several banks who attempted to manipulate the markets for their own benefit. It is incredible that they could have done this for such a prolonged period of time. As noted by the Treasury Select Committee, it does not look good that it was not spotted by either the Bank of England or the FSA.<sup>549</sup> But it indicates a prolonged period of weak internal compliance and board governance at Barclays, as well as a failure of regulatory supervision.

## Barclays

Over the past twenty years, Barclays has grown rapidly from a domestic retail bank to a global universal bank. Its investment banking arm had grown fast, acquiring parts of Lehman Brothers after it had collapsed. The bank has survived the financial crisis without requiring government support, raising capital on its own instead. In the years after the crisis, the bank was engulfed by negative publicity relating to conduct failures. It reached its pinnacle when on 2 July 2012 the CEO, Bob Diamond, resigned.<sup>550</sup> Mr Diamond, the stereo-typical, high-earning and outspoken American investment banker who had led Barclays Capital before becoming CEO, had become the focal point of what had gone wrong in the City. Under immense pressure from both politicians and the regulators following the LIBOR scandal, his position had become untenable. The bank announced in July 2012 a review of

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BBC, 'LIBOR scandal: RBS fined £390m' (6 February 2013) <<http://www.bbc.co.uk/news/business21348719>>

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BBC, 'Six banks fined £2.6 billion by regulators over forex failings' (12 November 2014) <<http://www.bbc.co.uk/news/business-30016007>>

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Treasury Select Committee, 'Treasury Select Committee publishes LIBOR report' (18 August 2012) <<http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasurycommittee/news/treasury-committee-publishes-libor-report/>>

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BBC, 'Barclays boss Bob Diamond resigns amid LIBOR scandal' (2 July 2012) <<http://www.bbc.co.uk/news/business-18685040>>

its business practices, to be led by Antony Salz. This has become known as the Salz Review.<sup>551</sup>

Some of the failures include under-investment in monitoring compliance, risk and other control processes leading to breaches of international sanctions. Related operational failures include a failure to segregate its own money from that of the customers. This occurred in 2009, for which the bank received a fine from the FSA. This made it difficult for customers to get any of their money back. Another failure was the failing in 2009 relating to submitting data of reportable transactions to the FSA, which it collects to detect and investigate market abuse such as insider trading and market manipulation. The bank did not have adequate systems and controls in place for this reporting requirement. It is reported that gross premium from Barclays PPI sales exceeded £400 million per year between 2003 and 2008, dropping slowly to less than £200 million after 2010, whilst the reported cost of meeting claims was under 25% of gross premiums for every year since 2002. Barclays made a profit from PPI between 2002 and 2012 of an estimated £940 million.

Schemes were designed to encourage staff to sell PPI, including a two and a half times higher commission for loans sold with PPI instead of without. When the FSA expressed concerns about PPI in 2009, Barclays was one of the banks that brought a challenge against the FSA and the Financial Ombudsman Service. The courts decided in favour of the regulators forcing banks, including Barclays, to review their PPI sales. The report concludes that Barclays was too slow in controlling the failures relating to PPI, e.g. in controlling the selling process and setting appropriate incentive schemes; in reacting to customer complaints; and in considering whether the high profitability was indicative of underlying problems.<sup>552</sup>

Barclays was involved in the mis-selling of interest rate swaps to small businesses, a practice started in 2001. This led to large number of complaints, since 2008 when interest rates reached a historical low. Following reviews by the FSA, Barclays launched a compensation scheme in 2012. Traders at Barclays Capital were involved in the LIBOR manipulation. The report concluded that this was due to deficiencies on the trading floor and a failure to embed ethical values. It was made worse by an ineffective control and supervision of traders and a lack of separation between those trading and those submitting the rates. There is one important point to be made: all these issues, and in particular the LIBOR manipulation, including the publication of communication between traders, have dented any trust and confidence that the public may have had in Barclays. This takes the analysis back to the role that banks play within the economy and why the stakeholders of the bank must include the public. To emphasize this point, consider the Structured Capital Markets team within Barclays Capital, which was a tax-led transaction structuring business. This was a profitable

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Antony Salz, 'Salz Review – An Independent Review of Barclays' Business Practices' (April 2013) <<http://online.wsj.com/public/resources/documents/SalzReview04032013.pdf>>

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business that assisted clients and Barclays itself in avoiding to pay taxes. Although Barclays operated in an open way with HMRC, and although there is no evidence to suggest that it aided tax evasion, this team was operating on the edge of highly abusive and aggressive tax avoidance schemes.

There are some recommendations made on how this can be achieved within Barclays. An examination of the responses to the failures at banks is a summary of the recommendations is insightful into the deeper reasons. The main ones include the second and fourth recommendations, which state that high values and standards must be set and that the board and senior management must be demonstrating these and carrying responsibility for implementing these. Responsibility for this lies with the top of the organisation, who perform an exemplary role. The third recommendation states that Barclays must develop an understanding of its customers and their needs. The customers' needs and objectives should be met whilst meeting the objectives within the organisation. This is connected with the recommendations with the sixth recommendation that a Code of Conduct must be published. This gives guidance to employees on how to behave in their work. The implication of these recommendations is that one of the deeper problems at Barclays was the importance of profit over customers, a principle emanating from the senior management all the way down the organisation. There is a set of recommendations that fall under the category of board effectiveness. It is recommended that a number of non-executive directors have banking experience. The non-executive directors must invest sufficient time to discharge their obligations. The board information should be comprehensive. This points to a deeper underlying problem with the capability and commitment of the board members in overseeing senior management at Barclays and the independent challenge that they provided.

There is a set of recommendations that relate to the human resource function, performance targets, pay and incentives. The human resource function was not sufficiently empowered to provide any direction on who was hired and on what staff were paid. A part of pay was linked to performance targets. These were linked to financial and sales targets. This provided a message to staff that the objective was to make money, regardless of any considerations or understanding the customers' needs. All these failures are failures of corporate governance.

## **The Co-operative Bank**

The failure of a bank due to a shortfall in capital is that of the Cooperative Bank. Linking this failure to the financial crisis might be considered somewhat of a stretch, perhaps by way of adverse economic conditions or increased capital requirements, it must be included in this research because it is the failure of a UK bank with a different model of operation and a different model of corporate governance. If the failure of the Cooperative Bank was not examined as part of this research, the conclusion might have been reached that its approach was a superior model of corporate governance that should be adopted without properly assessing its downsides. The bank has a cooperative model: its customers could become members of its parent, the Co-operative Group, and become owners. The bank has a policy,

which sets out many policy objectives.<sup>553</sup> These include acting with transparency, being a responsible bank that treat customers fairly and promoting economic and social development in Britain.

## Timeline

Before examining the problems, it is necessary to highlight some of the events in the bank's history because they contributed to its fall from grace. In 2009, the Co-operative Bank merged with Britannia Building Society.<sup>554</sup> Britannia had a risk appetite, which included concentrated commercial real estate lending. Due diligence was insufficient and provisions had to be made later. Britannia's financial position was deteriorating whilst merger discussions took place. In 2011, the FSA concluded that Britannia would have failed if there had been no take-over.

In 2011, the Co-operative Bank started its attempt to take over the part of Lloyds Banking Group which it was forced to split off to comply with EU rules on state-aid. This became known as Project Verde, including 632 branches in the UK and around 5 million retail customers. The Co-operative was struggling with the integration of Britannia, in particular the integration of IT systems was proving problematic. It would stretch its capital resources. Amid these concerns, which were voiced by the FSA, the bank decided to bring in a CEO to lead the transaction, which became its focus. Despite an independent report by KPMG at 2012, and warnings from the FSA that it would increase capital requirements, nobody at the bank considered pulling out of the deal. After critical reports and an increase in capital requirements, the Co-operative pulled out of the deal in March 2013. The Co-operative Bank was hit by the PPI mis-selling scandal. All of the mis-selling emerged from the Co-operative side, as Britannia had not been involved in this practice prior to the merger. As was the case with other banks, the income generated by PPI premiums outweighed the claims that were paid out. The bank had to make provisions of up to £347 million by the end of 2013, but it is concerning that the mis-selling practice was present at this bank despite its commitments. The costs of the PPI scandal, combined with the losses from Britannia's loans, Project Verde and from integrating the IT platform were eroding the bank's capital. After the increase in capital requirements by the FSA, the bank had to announce a £1.5 billion capital shortfall following an industry-wide exercise performed by the regulator. The bank was forced to negotiate a rescue packet with several US hedge funds, who would provide capital in return for 70% control in the bank.<sup>555</sup> It would result in the closure of around 50 branches. The part of the bank's fall from grace was the arrest of its former

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The Co-operative Bank, 'Our ethical policy' (20 January 2015) <<https://www.cooperativebank.co.uk/assets/pdf/bank/aboutus/ethicalpolicy/ethical-policy.pdf>>

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Sir Christopher Kelly, 'Failings in Management and Governance: Report of the independent review into the events leading to the Co-operative Bank's capital shortfall' (30 April 2014) <<http://www.cooperative.coop/PageFiles/989442031/kelly-review.pdf>>

555

BBC, 'Co-op bank to close 50 branches as part of rescue plan' (30 Nov 2013) <<http://www.bbc.co.uk/news/business-24802559>>

chairman, Reverend Paul Flowers, in connection with an investigation into the supply of drugs.<sup>556</sup>

### **The Kelly Review**

The question is whether one could run a bank with the Co-operative ideals and principles, or whether this case has proven that it is not possible. It is instructive to examine the conclusion of the Kelly report, written by Sir Christopher Kelly as an independent review into the events leading to the bank's capital shortfall. This report tells a story of failings on a number of levels. The Bank Executive failed to exercise prudent and effective management of capital and risk. The Banking Group Board failed in its oversight of the Executive. The Group Board failed in its duties as shareholder to provide effective stewardship of an important member asset. They failed to ensure that the Co-operative Bank lived up to its principles. In all these things they let down the Group's members. The lessons set out in Chapter 14 are far from novel. It does no credit to those involved that they should need to be learnt again.<sup>557</sup> The conclusion must be that these are failures of corporate governance.

The bank was held at arm's length from the group. It is understandable that there was some form of separation, if only due to regulatory regimes applicable to the bank but not to the group. At the Cooperative, the group's board would review a written statement provided by the bank without much challenge. The challenge would arise on values and principles, rather than on core banking matters. The report highlights two reasons for the lack of challenge. The first is ineffectiveness which arose from its size. But the second reason is the board's lack of experience in banking and finance. The board, consisting of elected members who had to spend their time on their re-election, did not contain any business experience. The report states that it was so bad, that several members needed financial terminology and concepts to be explained. The five representatives from independent societies had worked within the co-operative movement and lacked the required skills and knowledge. The consequences are clear: sustained success requires effective governance. Effective governance requires a high performing board. The composition of the Co-operative Group Board, and the limited pool from which its members were drawn, made a serious governance failure almost inevitable. The approach to the election of non-executive directors has shown incapable of producing a Group Board with the necessary governance competences or the business and technical skills required for successful stewardship of the Group's assets. It is Sir Christopher Kelly's damning assessment that these problems were bound to happen given the poor corporate governance. It is a proven element of good corporate governance that the board has the skills and expertise to oversee the group's complex portfolio of businesses. The board must have good management information to challenge the board.

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Jill Treanor, 'Former Co-op bank chairman Paul Flowers arrested in drug inquiry' (22 Nov 2013) <<http://www.theguardian.com/business/2013/nov/22/paul-flowers-former-coop-bank-chairmanpolice-arrest>>

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## The Myners Report

The views expressed in the Kelly review are confirmed by Lord Myners, who was appointed as Senior Independent Director to the Co-operative Group in December 2013, and who wrote an independent report on its governance.<sup>558</sup> He resigned four months later, noting a resistance to change, a denial of responsibility, deliberate delays and a hiding behind values within the group, amongst his reasons for leaving. In summarising his findings, Lord Myners notes that the present governance architecture and allocation of responsibilities is not fit for purpose.

This is in complete agreement with the conclusions reached by Sir Christopher Kelly. The recommendations made by Lord Myners are no surprise. The recommendation is to create a new Group Board, with an independent chair, 6 to 7 independent non-executive directors and two executive directors. This would ensure knowledge and skills are present on the board to provide the necessary challenge. It would remove the convoluted way in which the board is selected. Lord Myners outlines several proposals to re-organise the Areas and Regions into a different Membership Council and other committees. The point is his proposals seek to maintain the unique characteristics of a co-operative and they do not seek to convert it into a standard exchange listed company. The conclusion is that in order to achieve the social goals, the Co-operative Group must be a successful business. It needs to survive over the long term and generate healthy profits to build its capital base. This is important for this type of organisation because, it is not able to raise capital by issuing shares.

Value creation is necessary for value distribution amongst its members and to achieve any other social goals it might have. The case studies examined provide some answers to this research question. The case studies demonstrate that there can be no doubt that corporate governance at UK banks was weak. There were four themes that emerged which contributed to this weakness. These are the growth in complexity in financial markets, in products and in institutions leading to a higher standard; the lack of effectiveness at board level; ineffective systems and controls; and the problems associated with a lack of moral values and ethics. A far wider ranging and detailed analysis of the underlying crisis, which goes beyond the scope of this research, can be found in the report by the US Financial Crisis Commission.<sup>559</sup>

## The Growth in Complexity and Required Minimum Standard

Consider the growth and increasing complexity of both financial institutions and financial instruments in the decade before the crisis. Basel 1 was introduced as an international standard, to create a level playing field aimed at making banks safer. It is clear that the rules were simplistic; the risk weighting of assets left much to be desired. Regulators can be blamed for designing such a flawed system. But banks can be accused of abusing this system. Banks sought to gain maximum returns on their capital for the shareholders and allocated capital into assets that would attract a low regulatory risk weighting despite the

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) <[http://www.cooperative.coop/Corporate/PDFs/Myners/Report\\_of\\_the\\_Independent\\_Governance\\_Review.pdf](http://www.cooperative.coop/Corporate/PDFs/Myners/Report_of_the_Independent_Governance_Review.pdf)>

<sup>559</sup>

real-world risk they carried. Turning to securitized loans and mortgages, the Basel Committee reports that there were several reasons for an explosive growth in this area. There was a high demand for these products as they were perceived to be safe, confirmed by their rating, whilst they provided a high yield.<sup>560</sup> Common sense would dictate that something is amiss: there is a positive correlation between risk and return. Issuers weakened their asset screening and monitoring whilst investors did not understand the risk that they were taking on. There are some points to be made in relation to the research question. There is the element of working around legislation and reducing regulatory capital rather than the adherence to what regulation is trying to achieve. There is the creation of instruments so complex and non-transparent, that investors should not have been offered, although it was their own problem that they bought it. It is the observation that the complexity in financial innovation and financial instruments increased at an incredible pace over the decade proceeding the global financial crisis. Combined with the rise of financial behemoths that are coined too-big-to-fail, the financial industry had become more complicated and interconnected. This is supported by the evidence presented in some studies.

Northern Rock was a lender, but its aggressive growth plan was based on financial innovation. It sought to take many of its mortgages off its balance sheet via securitisation, thereby relying on short-term funding. Its systems and controls would have to be raised to a high standard to match the complexity of its business model. The skills and knowledge at board level would have to increase to understand the risks flowing from the business model and to understand the effects of reliance on international wholesale markets for funding. The problems demonstrate that the standard of corporate governance at Northern Rock was not raised, which led to its failure. During a period of aggressive expansion, including the growth of its CDO business and the take-over attempt of ABN Amro, the standard of what constituted good corporate governance kept being raised. The systems and controls at RBS were lacking. The understanding at senior management level of the business and products they were entering into was absent. The case studies of Barclays and the Co-operative Bank demonstrate the same or similar shortcomings arising of the increased complexity of its business, products and environment. Elements of what must be present can be identified. The standard and minimum requirements differ for each of the UK banks. It is the conclusion that, in the decade before the crisis, the standard for each UK bank was raised and all the UK banks covered in the case studies fell below its individually raised standard.

## **Elements of Corporate Governance**

### **Ineffective Board**

Where the previous conclusion related to the increased minimum required standard of corporate governance, that follow contain conclusions on elements of corporate governance. In the examination of the case studies, it was a recurring theme that these elements were absent or fell below the minimum required standard. The case study of Northern Rock was

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Basel Committee on Banking Supervision, 'Report on Asset Securitisation Incentives' (July 2011)  
<<http://www.bis.org/publ/joint26.pdf>>

ineffective in challenging its aggressive expansion. At HBoS, the board did not only lack experience in banking and finance, it was beating itself on the chest as a beacon of good corporate governance moments before its collapse. At both RBS and at Barclays, there was a dominant CEO, Sir Fred Goodwin and Bob Diamond respectively. Neither the board at RBS nor at Barclays could provide sufficient challenge. It resulted in the disastrous take-over at RBS and the spread of a profit-focused culture at Barclays. The case study making the strongest case of all for a strong board is that of the Co-operative Bank. It must be noted that, with the take-over of Britannia and Project Verde, the standard of what constituted good corporate governance kept rising without any changes being made to its governance. It was the conclusion of two reports, that the board at the Co-operate Group was ineffective and required an overhaul.

### **Ineffective Risk Management and Controls**

Another element of corporate governance that was missing in the case studies is that of effective risk management and controls. In the case of RBS, there was no defined risk appetite. It is impossible to decide whether new transactions or business plans fall within the risk appetite that senior management want the firm overall to adhere to. The risk reports that were written at RBS were backward looking instead of forward looking. When these risk reports would be discussed at board level, the CRO would not be in attendance. All these factors combined led to an ineffective risk management and control at RBS. This led to the situation that there was no understanding of the risks that the firm was running and what the consequences would be in adverse conditions. The firm was ill-prepared when the global financial crisis started. At Barclay the risks associated with how the profit was made were not sufficiently considered. The conclusion is that the risk management, systems and controls must be proportionate to the risks that the bank is taking. As with minimum standard of corporate governance, it is dependent on the specific bank.

### **Culture, Values and Ethics**

The element of good corporate governance that was missing throughout the case studies is a less tangible concept of culture, values and ethics. The scandals, such as PPI-mis-selling, interest rate swap mis-selling, money laundering, violation of international sanctions and market manipulation in LIBOR and foreign exchange markets, paint a picture of an industry sector that has lost its moral compass. The case study of Barclays revealed the existence of a lucrative unit advising on tax avoidance schemes that were on the aggressive side of the spectrum. It revealed a culture where profit was placed before customers' needs. The Co-operative Bank's image of the ethical bank was damaged, not just due to its losses and incompetence, but also following the arrest of its former chairman on drugs related charges. The banks fulfil an important economic function and it would be difficult to imagine an advanced society without them. They matter because of the consequences of a bank failure.

## Regulatory failures

### Bernard Madoff

Christopher Cox, the former SEC chairman, has recognized the organization's multiple failures in relation to the Bernard Madoff fraud.<sup>561</sup> Starting with an investigation in 1992 into a Madoff feeder fund that invested with Madoff, and which, according to the SEC, promised curiously steady returns, the SEC did not investigate indications that something was amiss in Madoff's investment firm.<sup>562</sup> The SEC has been accused of missing numerous red flags and ignoring tips on Madoff's alleged fraud.<sup>563</sup> As a result, Cox said that an investigation would ensue into all staff contact and relationships with the Madoff family and firm, and their impact on decisions by staff regarding the firm.<sup>564</sup> SEC Assistant Director of the Office of Compliance Investigations Eric Swanson had met Madoff's niece, Shana Madoff, when Swanson was conducting an SEC examination of whether Bernie Madoff was running a Ponzi scheme because she was the firm's compliance attorney. The investigation was closed, and Swanson subsequently left the SEC, and married Shana Madoff. Approximately 45 per cent of institutional investors thought that better oversight by the SEC could have prevented the Madoff fraud.<sup>565</sup> Harry Markopolos complained to the SEC's Boston office in 2000, telling the SEC staff they should investigate Madoff because it was impossible to legally make the profits Madoff claimed using the investment strategies that he said he used.<sup>566</sup>

### Allen Stanford

A similar failure occurred in the case of Allen Stanford, who sold fake certificates of deposit to tens of thousands of people, many of them working-class retirees. In 1997, the SEC's own examiners spotted the fraud and warned about it. But the Enforcement division would not

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Chung, Joanna (December 17, 2008). "Financial Times: SEC chief admits to failures in Madoff case". Ft.com.

562

Moyer, Liz (December 23, 2008). "Could SEC Have Stopped Madoff Scam In 1992?". Forbes. Archived from the original on February 1, 2009.

563

Weil, Jonathan. "Madoff exposes double standard for Ponzi schemes". Bloomberg News (Greater Fort Wayne Business Weekly).

564

Serchuk, David (December 22, 2008). "Love, Madoff and The SEC". Forbes.

565

"Little faith in regulators and rating agencies, as LP demand for alternatives cools off, finds survey".

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Markopolos, H (2010). No One Would Listen: A True Financial Thriller. John Wiley & Sons. pp. 55–60. ISBN 0-470-55373-1.

pursue Stanford, despite repeated warnings by SEC examiners over the years.<sup>567</sup> After the Madoff fraud emerged, the SEC took action against Stanford in 2009. The SEC settled a [wrongful termination](#) lawsuit with former SEC enforcement lawyer [Gary J. Aguirre](#) in June 2010. [Gary J. Aguirre](#) was terminated in September 2005 following his attempt to subpoena Wall Street figure [John J. Mack](#) in an insider trading case involving hedge fund [Pequot Capital Management](#);<sup>568</sup> [Mary Jo White](#), who was at the time representing Morgan Stanley nominated as chair of the SEC, was involved in this case.<sup>569</sup> While the insider case was dropped at the time, a month prior to the SEC's settlement with Aguirre the SEC filed charges against Pequot. The Senate released a report in August 2007 detailing the issue and calling for reform of the SEC.<sup>570</sup>

## Inspector General office failures

In 2009, the [Project on Government Oversight](#), a government watchdog group, sent a letter to congress criticizing the SEC for failing to implement more than half of the recommendations made to it by its [Inspector General](#).<sup>571</sup> According to POGO, in the prior two years, the SEC had taken no action on 27 out of 52 recommended reforms suggested in Inspector General reports, and had a pending status on 197 of the 312 recommendations made in audit reports. Some of the recommendations included imposing disciplinary action on SEC employees who receive improper gifts or other favors from financial companies, and investigating and reporting the causes of the failures to detect the Madoff ponzi scheme.<sup>572</sup> In a 2011 article by [Matt Taibbi](#) in [Rolling Stone](#), former SEC employees were interviewed and commented negatively on the SEC's Inspector General's office. Going to the [OIG](#) was well-known to be a career-killer.<sup>573</sup> Because of concerns raised by [David P. Weber](#), former SEC Chief Investigator, regarding conduct by SEC Inspector General [H. David Kotz](#), Inspector General [David C. Williams](#) of the [U.S. Postal Service](#) was brought in to conduct an

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Kurdas, Chidem. [Political Sticky Wicket: The Untouchable Ponzi Scheme of Allen Stanford](#).

568

Blaylock D. (June 2010). [SEC Settles with Aguirre](#). Government Accountability Project.

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[Choice of Mary Jo White to Head SEC Puts Fox In Charge of Hen House](#). Rolling Stone.

570

Committee on Finance, Committee on the Judiciary. [The Firing of an SEC Attorney and the Investigation of Pequot Capital Management](#). U.S. Government Printing Office.

571

Johnson, Fawn. (December 17, 2009) "[Group Alleges Slack SEC Response to Internal Watchdog](#)". NASDAQ.

572

Brian, Danielle. (December 16, 2009) "[POGO Letter to SEC Chairman Mary Schapiro regarding SEC's failure to act on hundreds](#)

573

[Is the SEC Covering Up Wall Street Crimes?](#), Matt Taibbi, [2006](#) August 17



independent, outside review of Kotz's alleged improper conduct in 2012.<sup>574</sup> Williams concluded in his 66-page Report that Kotz violated ethics rules by overseeing probes that involved people with whom he had [conflicts of interest](#) due to personal relationships.<sup>575</sup> The report questioned Kotz's work on the Madoff investigation, among others, because Kotz was a very good friend with Markopolos.<sup>576</sup> It concluded that while it was unclear when Kotz and Markopolos became friends, it would have violated U.S. ethics rules if their relationship began before or during Kotz's Madoff investigation.<sup>577</sup> The report found that Kotz himself appeared to have a conflict of interest and should not have opened his Stanford investigation, because he was friends with a female attorney who represented victims of the fraud.<sup>578</sup>

## Conclusion

Chapter 2 focused on the issue of the corporate governance crisis in the banking and finance sector. Corporate governance failures which contributed to various financial crimes in major banking institutions and those involved have been held sufficiently accountable in the USA and the UK. In this chapter, financial scandals such as WorldCom, Enron scandals, Parmalat, Barings Bank, Allfirst Bank, BCCI, Lehman Brothers, Northern Rock, Lloyds, HBos, the Royland Bank of Scotland and Barclays Bank were explored. We have reason to believe that the company failure, was mainly due to a combination of factors including corporate governance failure issues. The responsibilities of the directors and insider trading were also under consideration. Directors are subject to duties of loyalty and care. Directors operate under the favorable presumption that in making business decisions they will have acted on an informed basis, in good faith and in the honest belief that the decision was in the best interests of the company. The management and directors of engaged in insider dealing, a prohibited fraud in the US. The practice and timing of stock sales by managers and various board members can be viewed as indicative of their knowledge that the company would soon

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Schmidt, Robert (January 25, 2013). ["SEC Said to Back Hire of U.S. Capitol Police Inspector General"](#). Bloomberg.

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Schmidt, Robert; Joshua Gallu (October 26, 2012). ["Former SEC Watchdog Kotz Violated Ethics Rules, Review Finds"](#). Bloomberg.

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Schmidt, Robert; Joshua Gallu (October 26, 2012). ["Former SEC Watchdog Kotz Violated Ethics Rules, Review Finds"](#). Bloomberg. Robert Schmidt and Joshua Gallu (October 6, 2012). ["Former SEC Watchdog Kotz Violated Ethics Rules, Review Finds"](#). Business Week. Sarah N. Lynch (November 15, 2012). ["David Weber Lawsuit: Ex-SEC Investigator Accused Of Wanting To Carry A Gun At Work, Suing For \\$20 Million"](#). [The Huffington Post](#). ["David Kotz, Ex-SEC Inspector General, May Have Had Conflicts Of Interest"](#). [The Huffington Post](#). October 5, 2012.

577

Schmidt, Robert; Joshua Gallu (October 26, 2012). ["Former SEC Watchdog Kotz Violated Ethics Rules, Review Finds"](#). Bloomberg.

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Robert Schmidt and Joshua Gallu (October 6, 2012). ["Former SEC Watchdog Kotz Violated Ethics Rules, Review Finds"](#).

be plagued by financial chaos. In order to examine more UK and US regulatory issues, we are now moving to the next chapter as it is considered that the topic is also one of the important topics in this thesis. Besides, we may know more clearly about the Sarbanes-Oxley Act as well as Dodd-Frank Wall Street Reform and Consumer Protection Act. Corporate governance deficiencies highlighted in Chapter 2 prompts regulatory responses that will be discussed in Chapter 3.

## **Chapter 3**

### **Introduction**

After discussing the financial scandals in Chapter 2, this chapter discusses the UK and US regulatory response which took place in UK and in US. It provides a discussion of the Sarbanes Oxley Act, one of the most sweeping and controversial reforms in US legal history. An examination of executive pay and corporate integrity and corporate governance reforms give us a more complete picture of the corporate governance reforms and discussing with Dodd-Frank Wall Street Reform and Consumer Protection Act is crucial in this chapter.

### **UK and US Regulatory Response**

#### **The UK's response - The Higgs Report**

Despite a lack of large-scale corporate collapses in the UK, proposed UK reforms have been strongly influenced by the corporate scandals in the US. The proposed UK reforms originate from the Higgs report and the report of the Co-Coordinating Group on Audit and Accounting Issues under the chairmanship of Sir Robert Smith. The central theme of the Higgs report was the significance and role of non-executive directors in the management of a public company. Higgs recommended that the composition of the board of a UK public company should comprise 50% independent non-executive directors. Higgs sought to define an independent non-executive director as a person who sits on the board free of any potential conflict of interest. The proposals are modest but can contribute to good corporate governance standards in the UK, whilst the comply or explain principle ensures that they should be flexible enough to avoid being seen as overly prescriptive. Interpretation is important and the boards of companies must approach the proposals in an objective and sensible fashion in order to adopt those suitable to them and adapt those that need to be tweaked. Failure to comply should not be taken as a negative sign by investors, providing it

is accompanied by an adequate explanation that shows how governance standards are not compromised by the decision. It is important that the proposals are not interpreted so flexibly that they lack substance, nor so rigidly that they become a straitjacket.<sup>579</sup>

## **The Companies (Audit, Investigations and Community Enterprise) Act 2004 and CA 2006**

The UK government, in seeking to protect and improve the standards and competency of business practices considers that robust regulation of auditors as key to achieving its objectives. The corporate failures in the USA have shocked and perhaps caused some degree of panic in respect of the UK government's desire to reform the regulatory framework of corporate and financial markets. Besides, sections 170-181 of CA 2006 and subsections (2) to (8) of FSMA 2000, ss 118 sets out different types of behavior which are defined as constituting market abuse.

## **The US response - Sarbanes-Oxley Act (SOX)**

The Sarbanes-Oxley (SOX) has been called the most sweeping corporate regulation measure in decades. Congress intended to assure that auditors would point out financial shenanigans by their corporate clients before fraud or conflicts of interest can hurt a company, its employees and its investors. Just what constitutes a conflict of interest, remains a topic of heated debate. In the wake of Enron-Anderson and subsequent scandals, Sarbanes-Oxley prohibits public accounting firms that audit companies from providing certain services, such as internal audits and financial information systems design. Notably tax services remain permissible for audit firms, but the Public Company Accounting Oversight Board could prohibit such services.<sup>580</sup> Maintaining strong and efficient controls is of critical importance. Besides, one of the main objectives of the Sarbanes-Oxley Act was to restore investors' confidence in financial reporting. Its success should be measured on the basis of whether the Act has helped in maintaining the public's confidence. As far as poor stock returns are concerned, a behavioral perspective would suggest that it is possible that SOX-complaint firms experienced poor post-SOX stock returns because they lost their abilities to fool naive investors.<sup>581</sup> The Sarbanes-Oxley Act is a decisive step in the right direction and a strong shield against corporate fraud. It sends a signal that such events should never happen again.<sup>582</sup>

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Trade and Industry Committee, The White Paper on Modernising Company Law, London, July 2002, Cm 5553-I, part I, para 3, available in the website: <http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtrdind/439/439.pdf>.

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Debate over the issue continues in the realm of public opinion, where best practices are effectively established.

<sup>581</sup>

Iliev, P., "The effect of the Sarbanes-Oxley Act (Section 404)", (2007), Job Market Paper, available at SSRN: <http://ssrn.com/abstract=983772>

<sup>582</sup>

The Sarbanes-Oxley Act, adopted on 30 July 2002 in the wave of a series of scandals, delivered a rapid response. The Act unfortunately creates a series of problems due to its outreach effects on European companies and auditors, and the Commission is engaged in an intense regulatory dialogue with a view to negotiating acceptable solutions with the US authorities. In many areas, the EU shares the same broad objectives and principles of the Sarbanes-Oxley Act and in some areas robust, equivalent regulatory approaches exist in the EU. In some other areas, new initiatives are necessary. Earning the right to be recognised as at least equivalent alongside other national and international rules is a legitimate and useful end in itself.<sup>583</sup>

### **Corporate malfeasance and corporate misfeasance**

Ensuring effective and proportionate protection of shareholders and third parties must be at the core of any company law policy. A sound framework for protection of members and third parties, which properly achieves a high degree of confidence in business relationships, is a condition for business efficiency and competitiveness. In particular, an effective regime for the protection of shareholders and their rights, protecting the savings and pensions of millions of people and strengthening the foundations of capital markets for the long term in a context of diversified shareholding within the EU, is essential if companies are to raise capital at the lowest cost.<sup>584</sup>

Corporate malfeasance is the commission of an unlawful act, while corporate misfeasance is an improper performance of some essentially lawful act.<sup>585</sup> Back when Enron was an admired even if opaque, the company and the stock markets were soaring and investors had little time to worry about corporate integrity, ethics and accountability. But the crash of 2001 and the financial scandals that followed have changed that. The once-arcane subject of corporate governance has been pulled into the spotlight as public companies, politicians and government regulators try to show Americans that it's safe once again to put their faith and their cash in Corporate America. Assessing Sarbanes-Oxley Act and its impact / Sarbanes-Oxley in the US does not appear to be able to deter Corporate Governance flaws in banking.

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Brickey, K., "From Enron to Worldcom and Beyond: Life and crime after Sarbanes-Oxley", (2003), Washington University Law Quarterly, Vol. 81, 381

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European Commission, Communication 0284/2003 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward', available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.

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European Commission, Communication 0284/2003 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward', available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.

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The Highways Act 1980, S58; Griffiths v Liverpool Corporation (1967)1 QB. 374

The strongest case for the Sarbanes-Oxley Act was argued by Charles Niemeier, one of five members of the Public Company Accounting Oversight Board.

Although SOX was enacted with near unanimity in 2002, only a few years thereafter, four high-profile commissioned reports critiqued the legislation for having adverse economic consequences for small firms and capital markets. These critiques contributed to increasing media coverage of SOX's impact. Examination of the coverage of the SOX critiques yields three core findings. First, reporting on the critiques increased as media references to Enron receded, although the term "Enron" has entered the vernacular and its newspaper presence dwarfs that of the SOX critiques. Second, market competitiveness issues tend to receive greater media attention than small firms' costs, although these concerns are not necessarily mutually exclusive. This reporting pattern is consistent with three of the four commissioned reports' emphasis on market competitiveness issues. Third, and most intriguing from a political economy standpoint, regional newspapers and the Washington Post devoted equal attention to small firm compliance costs and capital market competitiveness issues and hence provided greater relative coverage of small firm costs than did the New York-based national press.<sup>586</sup>

### **Reasons for Passage of the Act and Its Main Components**

This section is to give a brief overview of the ongoing debate in the literature concerning the main thrust of the Sarbanes-Oxley Act, as well as different angles on its effect on the corporate sector in the US and whether the issues that it is meant to remedy are being addressed. The driver for the passage of the Sarbanes-Oxley Act of 2002 was the desire to address issues of insufficient corporate governance processes in the US corporate sector, which had been brought to light shortly before by the corporate scandals involving companies such as Enron, WorldCom, Arthur Andersen and others. Bergen describes the situation at the time: in the wake of the 2001-2002 Arthur Andersen accounting scandal and collapse of Enron and WorldCom, the government, the investors and the American public demanded corporate reforms to prevent similar future occurrences.

Viewed to be largely a result of failed or poor governance, insufficient disclosure practices, and a lack of satisfactory internal controls, in 2002 Congress passed the Sarbanes-Oxley Act seeking to set standards and guarantee the accuracy of financial reports. Romano states: "SOX was enacted in a flurry of congressional activity in the run-up to the midterm 2002 congressional elections after the spectacular failures of the once highly regarded firms Enron and WorldCom". In her examination of the Act and the proceedings leading up to its passage Romano was critical of some of the law's components, as well as its make-up as a whole. An example for Romano's criticism is her opinion of section 301 of SOA that requires all listed companies to have audit committees composed entirely of independent directors: there are fewer studies of the relation between audit committee composition and firm performance. One proponent of this school of thought is Bumgardner who states

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Romano, R., 'Does the Sarbanes-Oxley Act Have a Future?' (2009), Yale Law & Economics Research Paper No. 385, pg. 114, available in the website: <http://ssrn.com/abstract=1404967>.

regarding the very same provision. The audit committee of the board of directors at any public company gains new power and responsibilities, and there are more safeguards to ensure that audit committee members are not controlled by top management. (Bumgardner, 2003). In evaluating the Act in terms of it preventing future scandals Ribstein broadly dismisses its utility and would rather see an unimpeded response by the market itself in addressing the problems. Markets are capable of responding more quickly and precisely than regulation to corporate fraud, as long as regulation does not impede or mislead them.

The Sarbanes-Oxley Act is a landmark piece of legislation as far as disclosure, enhanced corporate accountability and responsibility, independence of audit committees and financial reporting is concerned. It was created as a means to prevent fraudulent behaviour in financial statements and to restore investors' confidence after the hurricane of corporate scandals that razed the corporate governance construction to the ground. This divergence goes beyond the self-evident division between supporters and critics. There are critics who have reservations about its effectiveness and draw attention to the compliance costs.<sup>587</sup> They consider the Act to be nothing more than a patchwork and codified response by Congress to widely publicized financial scandals', with no direct impact on improving corporate governance and financial disclosures, at least beyond those of market-based mechanisms.<sup>588</sup> Other critics concluded that the Act's costs are substantial, while the benefits are small, and have described the Act as quack corporate governance.<sup>589</sup> Like Bainbridge, focus on the political motivation behind it and the quality of its content. Congress and the regulators have implemented a set of reforms that are deeply flawed. They have adopted policies that have no empirical support or economic justification. Worse yet, they have eviscerated basic federalism rules that have long served us well.<sup>590</sup> He concluded that the Act sacrificed the American economy at the altar of short-term political gain.<sup>591</sup>

There are scholars who have suggested that the Act's importance has been overstated and predicted its effect to be modest.<sup>592</sup> Perino asserts that the Act was in reality a response to the increased political fire storm and the pressure on the Congress, as the new criminal

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See Ribstein, L., *Market vs. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes Oxley Act of 2002*, (2002), *Iowa Journal of Corporate Law*, Vol. 28, No. 1, pg. 1.

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Rezaee, Z. and Jain, P. K., 'The Sarbanes-Oxley Act of 2002 and Security Market Behaviour: Early Evidence', (2006),

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See Romano, R., *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, (2005), *Yale Law Journal*, Vol. 114,

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Bainbridge, S.M., *The Creeping Federalization of Corporate Law*, (2003) *Regulation*, at 30, available at the website: <http://ssrn.com/abstract=389403>; see Bainbridge, S.M., *Director Primacy: The Means and Ends of Corporate Governance*, (2003) 97 *Nw.*

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Bainbridge, S.M., *Sarbanes-Oxley: Legislating in Haste, Repenting in Leisure*, (2006), *UCLA Sch. of Law, Law & Econ.*

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Among others, see Cunningham, L., *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Just Might Work)*, (2003), *Connecticut Law Review*, Vol. 35, 915 and Ahdieh, R.B., *From "Federalization" to "Mixed Governance" in Corporate Law: A Defence of Sarbanes-Oxley*, (2005) 53 *BUFF. L. REV.* 721, 721-23.

liability provisions criminalized little conduct that was not criminal under existing statutes.<sup>593</sup> The reform measures reflected previously accumulated policy positions that were based on experience, anecdotes, general policy arguments, and the outcome of long-running competitive posturing by good corporate governance proponents and their targets.<sup>594</sup> There are supporters, who are convinced that the Act will improve corporate governance and strengthen financial markets in the long-run. Wiesen suggested that it is as broad an attempt to correct free market externalities as any legislation passed by the federal government in memory, it deals with what people do, not where securities go.<sup>595</sup> A study of the early evidence of the SoX found that it has served as a stimulus to encourage initiatives for rebuilding the public confidence in corporate governance, the financial reporting process, and audit functions. The SoX had a positive effect on the accuracy of financial disclosure, as the increasing number of restatements among all types of companies, but particularly larger ones, since its adoption has indicated.<sup>596</sup> The early evidence in 2006 showed that the over-valuation that resulted from the inaccurate financial statements was estimated at \$63 billion on an adjusted basis.<sup>597</sup>

Companies had to meet higher standards not only due to the SoX coming into force, but also pursuant to the updated listing rules adopted by the stock exchanges. Regarding the costs, new legislation created new incentives for companies to spend more money on internal audits, above and beyond the significant increase in audit costs after the scandals. In exchange for these higher costs, SoX promised a variety of long-term benefits, such as a lower risk for investors of losses from fraud and theft, more reliable financial reporting, and greater transparency and accountability, while the American economy would benefit from a better allocation of resources and faster growth.<sup>598</sup> The Listing Rules were helpful to companies as additional guidance for improving their organization and their function, because these rules were constructed in such a way as to be compatible with the spirit of the SoX.

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Perino, M., Symposium Enron and its Aftermath: Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002, (2002), 76 St. John's L. Review. 671-698. See Gordon, J., Governance Failures of the Enron Board and the New Information Order of SarbanesOxley, (2003), Columbia Law and Economics Working Paper No. 216; Harvard Law and Economics Discussion Paper No. 416 and Bainbridge, S., and Johnson, C., Managerialism, Legal Ethics, and Sarbanes-Oxley Section 307, (2003), Law Review of the Michigan State University-Detroit College of Law, Research Paper No. 03-13.

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Clark, R.C., Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too, (2005), Discussion Paper No. 525, 22 Georgia State Law Review 251- 291 at 253.

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Wiesen, J., Congress Enacts Sarbanes-Oxley Act of 2002: A Two-Ton Gorilla Awakes and Speaks, (2003), Journal of Accounting, <sup>596</sup>

Reilly, D., Restatement Blame: Basic Mistakes', WALL ST. J., Nov. 20, 2006, at C4 in Brown, Jr., R., Criticizing the Critics: <sup>597</sup>

U.S. Gov. Accountability Office, GAO-06-678, Update of Public Company Trends, Market Impacts, and Regulatory Enforcement <sup>598</sup>

Coates, J.C. IV, The Goals and Promise of the Sarbanes-Oxley Act, (2007), Journal of Economic Perspectives, Vol. 21, No. 1, 91-116 at 92.

Moving to auditors, auditing companies were also affected by the SoX, because there were many academics, who were talking about failure of the gatekeepers<sup>599</sup> as one of the causes of the corporate failures. For instance, Coffey Jr and Tomasic have stressed the critical role of these gatekeepers in corporate law and their responsibility in the context of corporate scandals.<sup>600</sup> A number of auditing failures revealed the cracks in the foundations of the auditor's system of self-regulation long before Enron and the passing of the SoX. Ernst & Young had to pay a record \$335 million for the settlement of a single shareholder lawsuit in 2000. Apart from the normal auditing services, the Big Four, PricewaterhouseCoopers LLP, Ernst & Young LLP, KPMG LLP and Deloitte & Touche LLP, were providing lucrative consulting services, and in certain occasions some auditors ceased being the emperor's gadfly and became his compatriot. As Healy and Palepu argued, auditing had for a long period been suffering from a deprofessionalization – a loss in the capacity of auditors to detect fraud - because of increased competition, diminishing audit fees, and persistent liability risks, which reduced long-term rewards for auditing and increased incentives for rule-based accounting requiring little discretion or professional expertise.<sup>601</sup>

DeFond and Francis noted that the SOX has transformed the auditing industry from a self-regulated industry to one industry controlled by a quasi-government agency, the PCAOB.<sup>602</sup> Post-SoX auditors are expected to be more vigorous and more dynamic in their role as gatekeepers. Despite that SoX forced them to change their operation and their relationship with their clients, the Big Four can be characterized as the principal financial beneficiaries of section 404, due to the lucrative revenue stream from internal control audits.<sup>603</sup>

One of the big flaws of SoX that is not related to the wording of the provisions or the enforcement strategy is that it does not focus on the source of the real problem: the pressure placed on managers by the disclosure of the quarterly results.<sup>604</sup> The shareholder value

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The term has been applied to include auditors, accountants, lawyers, securities analysts, rating agencies and even boards of directors, see Coffee, Jr., J., *Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation*, (1999), 52 *Bus. Law.* 1195, 1210-13, 1232-33. See Coffee, Jr., J., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, (2004), 84 *B.U. L. Rev.* 301, 354.

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Coffee, Jr., J., *Gatekeeper – The Professions and Corporate Governance*, Oxford University Press, Oxford, 2006. See Tomasic, R., *Corporations Law Enforcement Strategies in Australia: The Influence of Professional, Corporate and Bureaucratic Cultures*, (1993), 3 *Australian Journal of Corporate Law* 192-229.

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Healy, P. and Palepu, K.G., *How the Quest for Efficiency Undermined the Market*, (2003), *Harvard Business Review*, available in the website: <http://ssrn.com/abstract=422524>. See also Levit, Jr., A., *Accounting and Investor Protection Issues Raised by Enron and Other Public Companies*, (2002), presented at U.S. Senate, Committee on Banking, Housing and Urban Affairs Hearing, February 12, 2002.

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DeFond M. and Francis, J., *Audit research after Sarbanes-Oxley*, (2005), *Auditing: A Journal of Practice and Theory* 24 (Supplement), 5-30.

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Romano, R., *Does the Sarbanes-Oxley Act Have a Future?* (2009), *Yale Law & Economics Research Paper* No. 385, pg. 103, available in the website: <http://ssrn.com/abstract=1404967>.

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theory was not applied correctly and failed to guide managers and directors in their decisions. A closer look at the SoX provisions shows that no reference was made to this problem and no relevant arrangement was made. New legislation did little to alter the incentives for corporate leaders to take excessive risks, as corporate culture continues to reward managers, who are willing to take risks and do not second guess the genius of their decisions.<sup>605</sup> The SoX has been profoundly influenced by the shareholder value theory and in this way instead of attacking the root of the evil, fertilizes it.<sup>606</sup>

Supervision was indeed defective and gate-keeping mechanisms were malfunctioning, but the crisis was deep and it penetrated to the very foundations of the corporate governance system.<sup>607</sup> The struggle to keep the stock prices up, to maximize profits, and to achieve high returns through stock options and bonuses led to irrational choices and fraudulent activity. Companies became vulnerable, and the rest is history. The United States has the most diverse and efficient capital markets in the world, Thomas Friedman wrote in 1997, which reward, and even celebrate, risk-taking.<sup>608</sup> A lot seems to have changed since then, the days of euphoria belong to the past and memories from the distant 1930s have returned in the US stock markets. But while in the 1930s the prevailing perception was that investors had been defrauded by offerings of dubious quality securities, in the new millennium, investors' perception is that they have been defrauded by managers who are not accountable to anyone.<sup>609</sup> The Sarbanes-Oxley Act lacks a provision that would serve as a reminder to everyone that, apart from following the rules and avoiding conflicts of interest, business people should try to inspire an ethical corporate culture, because only in an ethical business environment will disclosure, independence, accountability and diligent oversight achieve their goals. The need for a radical change in the internal culture of all companies should have been highlighted and the spirit of the SoX should have led CEOs and CFOs to a u-turn: back to an ethical model of entrepreneurship. Emphasis on the admittedly broad principles of ethical compliance and monitoring, and the clearly articulated demand and expectation that managers behave ethically, will reduce risks, protect investors and slowly eliminate corporate malfeasance.<sup>610</sup>

### **Executive pay & corporate integrity**

Aglietta, M. and Reberlioux, A., *Corporate Governance Adrift: A Critique of Shareholder Value*, Edward Elgar, Cheltenham, 2005, pg. 246-7

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Skeel, D., *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From*, OXFORD

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607 Ibid.

608 Ibid.

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Friedman, T., 'Dear Dr Greenspan', New York Times, February 09, 1997, sec 4.

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Zingales, L., 'The Future of Securities Regulation', (2009), Chicago Booth School of Business Research Paper No. 08-27; FEEM Working Paper No. 7.2009, abstract.

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Starks said that during the 1990s, it seemed as though CEOs were being generously rewarded for having the good fortune of riding the economic boom. Sherron Watkins, the Enron whistleblower said compensation plans such as Grasso's are unnecessary as well as excessive. She suggested that a dozen competent candidates would line up for Grasso's old job if it paid a mere \$2 million a year. During a CEO response panel, EDS Chief Executive Michael Jordan said that institutional investors have been pressuring corporate boards to tie salaries more closely to the company's performance. He said compensation might be the best method to pay top executives. Dell Inc. Chairman and CEO Michael Dell, in a Q-and-A segment with Business Week Managing Editor Mark Morrison, said that Congress cannot legislate ethics. Sometimes, team players not involved in running the organization provide the best examples of doing the right thing.

### **The UK governance framework for bank executive remuneration**

Prior to the banking crisis, there was no legal or regulatory rule specifically targeted at bank executive remuneration matters, albeit the FSA (later the FCA) Handbook implicitly covered bank executive remuneration by way of requiring responsible and effective organisation and control of bank affairs, adequate risk management system, and robust governance arrangements.<sup>611</sup> As a corollary, banks' executive remuneration practices were in effect subject to the same remuneration rules and guidance as those designed for generic companies, possibly in the belief that bank executive remuneration matters were no different from those of non-financial firms.<sup>612</sup>

The governance framework for executive remuneration, focusing upon directors' remuneration matters, is designed to align executive remuneration with the long-term interests of shareholders<sup>613</sup> and to manage the conflicts of interest in setting executive remuneration. The remuneration issues below the board level are usually not within the regulatory remit, the reason for which may lie with the very heart of the conventional theory of corporate governance. The conflicts of interest, derived from the Companies (Model Articles) Regulations 2008<sup>614</sup> (SI 2008/3229), which allows executive directors to set their own remuneration,<sup>615</sup> are nothing but equity governance problems. In fixing this market

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Wade, C.L., *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?*, (2008), 39. *Loyola University Chicago Law Journal*, Vol. 39, 595- 611 at 611.

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Principle 3, SYSC 4.1.1R, 6.11R, 6.1.4R, and 7.1.16R.

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House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City'.

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FRC, 'The UK Corporate Governance Code', at D.1.

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SI 2008/3229

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Schedule 3 Model Articles for Public Companies, Article 23(2)(a).

failure, courts have been reluctant to make a judgement on the substance of directors' remuneration for fear of risking a distorting effect on the market force in setting appropriate director remuneration. The court will not determine directors' remuneration in a company, provided the articles of association of the company have specified how director remuneration is determined.<sup>616</sup> Where a director's remuneration is paid, the court does not assess remuneration levels and compare the market value of the director's services with the amount of remuneration paid.<sup>617</sup> The court must be satisfied that the payment is genuinely remuneration and not a transaction disguising an illicit return of capital to the shareholders.<sup>618</sup>

UK company law instead manages the conflicts of interest/equity governance problems involved in the setting of directors' remuneration by enhancing market discipline through public disclosure of a directors' remuneration report<sup>619</sup> and a mandated advisory vote on the report by shareholders at an annual general meeting.<sup>620</sup> The conflicts of interest/equity governance problems matter is further dealt with by the Corporate Governance Code, which recommends delegating directors' remuneration matters to an independent remuneration committee composed exclusively of non-executive directors and bars self-interested directors from presenting or voting on their own remuneration.<sup>621</sup> These three interlinked governance mechanisms, i.e. independent Board/remuneration committee monitoring, disclosure and shareholder voice, which were set under the Companies Act 2006 (c.46), UKLA Listing Rules, the Corporate Governance Code and institutional investors' (e.g. the Association of British Insurers (ABI)) guidelines, constitute the generic governance framework for executive remuneration. Due to the UK banking crisis, the governance framework for bank executive remuneration has been transformed. For the purpose of fixing the debt governance problems, it has been extended beyond the generic framework's three governance mechanisms to include the FSA's supervision and stakeholder monitoring, and embodies remuneration-related rules and guidance under the FSA Handbook (in particular its Remuneration Code<sup>622</sup>) and the Financial Services Act 2010 (c.28), apart from those applicable to generic companies. In particular, the Financial Services Act 2010 (c.28) and the Executives' Remuneration Reports Regulations 2010, explicitly entitle debenture holders

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617 Re Richmond Gate Property Co Ltd [1965] 1 WLR 335. Guinness plc v Saunders [1990] 2 AC 663.

618 Re Halt Garage (1964) Ltd [1982] 3 All ER 1016 at 1039.

619 Ibid.

Companies Act 2006 (c.46), Section 429.

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Ibid. Sections 439, 440.

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FRC, 'The UK Corporate Governance Code', at D.2.

622

An outline of the FSA Remuneration Code.

to the right to receive copies of the report. The framework regards the bank board/remuneration committee as central to executive remuneration governance, the FCA has been given, under the Financial Services Act 2010 (c.28),<sup>623</sup> the power to veto the board's decisions on remuneration.

### **The remuneration committee of a quoted bank**

The remuneration committee of a quoted bank, having delegated responsibility from the board with respect to executive remuneration,<sup>624</sup> is at the centre of a bank executive remuneration governance framework. In the UK, remuneration committees have been established in quoted companies since the early 1990s in response to the Cadbury Report (1992).<sup>625</sup> Their role is discussed in the Greenbury Report (1995),<sup>626</sup> the Hampel Report (1998) and the Combined Code on Corporate Governance (1999; 2003; 2006). The Combined Code (2003; 2006) gives a greater prominence and empowerment to non-executive directors on the remuneration committee with a particular emphasis on them being independent.<sup>627</sup> Due to the banking crisis, the Combined Code has been replaced by the Corporate Governance Code without amendment to the requirements in respect of a remuneration committee. In view of the various detrimental incentives which bank executive remuneration may create and the past deficiencies in bank executive remuneration governance,<sup>628</sup> a remuneration system in a UK bank is called for which is actively controlled and monitored by independent remuneration committees with the necessary expertise in risk management, risk governance and remuneration and extended responsibilities.

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624 Financial Services Act 2010 (c.28), Section 6.

FRC, 'The UK Corporate Governance Code', at D.2. SYSC 19.2.1R, 19.3.11E.

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Cadbury, 'The Financial Aspects of Corporate Governance'.

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R. Greenbury, 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury', (London: Gee Publishing, 1995).

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C. Pass, 'Non-Executive Directors and the UK's New Combined Code on Corporate Governance', The Bradford University School of Management Working Paper No 06/36 (2006).

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations'. House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City'. FSA, 'Consultation Paper 09/10: Reforming Remuneration Practices in Financial Services'.

Remuneration committees are put forward as the logical solution to the problem of the conflicts of interest within the board, and are designed to objectify the pay setting process.<sup>629</sup> Bank corporate governance framework in the UK is, arguably, based upon the assumption that sound bank governance can be buttressed by independent non-executive directors who act in the interests of the bank and its shareholders as well as the wider public to the extent that is required by law and financial regulation. An independent remuneration committee can help narrow the information and monitoring gap to which shareholders and bank supervisors are exposed due in part to the information asymmetry and resource constraints.<sup>630</sup> As was evident in the banking crisis, even an apparently independent remuneration committee may be conflicted. The remuneration committee of a quoted bank in the UK is comprised of at least three independent non-executive directors.<sup>631</sup> This procedural requirement may not by itself be adequate in eradicating a conflicted remuneration committee, which may use the pay-setting process to set executive remuneration to the detriment of the bank, its shareholders,<sup>632</sup> and the wider public. A case in point is that of Sir Fred Goodwin's bonus and pension payments. Too often the board and their remuneration committee in UK banks appear to have operated as cosy cartels, with non-executive directors yielding to pressure from executives, reluctant, as the ABI notes,<sup>633</sup> to avoid excessive remuneration arrangements for executives by setting relatively undemanding performance targets, and, as the FSA observes,<sup>634</sup> to eliminate excessive risk-taking incentives.

A bank non-executive director is likely to have a strong interest in keeping his directorship in the bank, which promises benefits, in the form of business opportunities, prestige, and social ties.<sup>635</sup> A dominant chief executive may prejudice the appointment of independent non-executive directors and the independence of the pay-setting process.<sup>636</sup> A bank non-

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Greenbury, 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury', at paras.2, 4.

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Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 86.

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FRC, 'The UK Corporate Governance Code', at D.2.1.

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G. Ferrarini et al., 'Reforming Company and Takeover Law in Europe', (Oxford: Oxford University Press, 2004) at 301-3.

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House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at 71.

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FSA, 'Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules'.

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M.B. Dorff, 'Softening Pharaoh's Heart: Harnessing Altruistic Theory and Behavioral Law and Economics to Reign in Executive Salaries', *Buffalo Law Review*, 51/3 (2003), 811 at 848.

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L.A. Bebchuk, 'The Case for Increasing Shareholder Power', *Harvard Law Review*, 118/3 (2005), 833 at 833.

executive director may not be willing to challenge a dominant chief executive's remuneration arrangements in order to protect his directorship at the bank.<sup>637</sup> As a US lawyer says, only a small number of directors would take up a post without receiving wholehearted approval from the CEO.<sup>638</sup> There is a concern regarding mutual back scratching between bank directors who hold cross-directorships.<sup>639</sup> Bank directors seeking executive positions may have incentives to adopt executive-friendly remuneration policies and arrangements.<sup>640</sup> The true independence of bank non-executive directors may be adversely affected by a number of social and psychological factors. A non-executive director may have close personal relationships with an executive.<sup>641</sup> Team spirit may encourage a board/remuneration committee to avoid direct conflict over executive remuneration issues,<sup>642</sup> in particular when the downsides of making executive-friendly remuneration decisions are relatively low and executive remuneration arrangements can be effectively camouflaged.<sup>643</sup>

A remuneration committee consisting exclusively of independent members may not be ideal.<sup>644</sup> Some studies suggest that there is no specific relation between increased board independence and improved remuneration policies<sup>645</sup> and between board independence and long-term performance of a company.<sup>646</sup> An empirical study focusing on banks produces even more surprising findings. Adams finds that banks supported by bailout funds had more independent boards and the bank directors earned significantly less remuneration than directors of non-financial institutions, indicating that formal board independence may not necessarily benefit banks and that independent directors may not always have the expertise necessary to adequately oversee complex banks. One way to address this issue, as the FSA Remuneration Code requires, may be to make sure that an independent remuneration

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<sup>638</sup> Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 30.

<sup>639</sup> D. Nasaw, 'Opening the Board: The Fight Is on to Determine Who Will Guide the Selection of Directors in the Future', Wall Street

<sup>640</sup> Greenbury, 'Directors' Remuneration: Report of a Study Group Chaired by Sir Richard Greenbury', at para.4.8.

<sup>641</sup> Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 30-1.

<sup>642</sup> Ibid.

<sup>643</sup> S.C.Y. Wong, 'Uses and Limits of Conventional Corporate Governance Instruments: Analysis and Guidance for Reform', working

<sup>644</sup> For evidence from the US, see I. Anabtawi, 'Secret Compensation', North Carolina Law Review, 82/3 (2004), 835 at 838.

<sup>645</sup> J. Core, R. Wayne, and R. Thomas, 'Is US CEO Compensation Inefficient Pay without Performance?', Michigan Law Review, 103/2 (2005), 1142.

<sup>646</sup> S. Bhagat and J. Black, 'Uncertain Relationship between Board Composition and Firm Performance', Business Law, 54 (1999), 921 at 931.

S. Bhagat and J. Black, 'The Non-Correlation between Board Independence and Long-Term Firm Performance', Journal of Corporation Law, 27/2 (2002), 231 at 231.

committee has appropriate resources and assistance to make informed remuneration decisions.<sup>647</sup>

The responsibilities of remuneration committees of UK listed banks and banking groups can be listed as follows: regulatory responsibilities required by the FCA<sup>648</sup> in respect of information disclosure<sup>649</sup> and accountability to the FCA, risk alignment of remuneration and risk management consistency of remuneration,<sup>650</sup> documenting procedures, and approving and reviewing of the remuneration policies on a firm-wide basis and more specifically in respect of approved persons with significant influence functions<sup>651</sup>; criminal responsibilities for producing, and submitting to the general meeting for advisory vote, an annual directors' remuneration report under the Companies Act 2006 (c.46); comply or explain responsibilities under the Corporate Governance Code, including: disclosure responsibility - to disclose the responsibilities of the committee and explain the role and power conferred upon by the board,<sup>652</sup> and to disclose the other relations between remuneration consultants and the bank;<sup>653</sup> responsibilities for appointing a remuneration consultant in respect of executive directors' remuneration;<sup>654</sup> responsibilities for setting the remuneration of all executive directors and board chairman but not the remuneration of non-executive directors<sup>655</sup>, and for recommending and monitoring the level and structure of non-executive directors and of executives below board level;<sup>656</sup> and, informal responsibilities under the ABI remuneration guidelines, which have certain impacts upon remuneration practices at listed

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648 FSA, 'Consultation Paper 09/10: Reforming Remuneration Practices in Financial Services', at 15.

The FSA Remuneration Code.

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SYSC 19.3.2G.

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SYSC 19.3.15R, 19.3.16E. <sup>575</sup> SYSC 19.3.3E.

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SYSC 19.2.1R, 19.3.11E.

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FRC, 'The UK Corporate Governance Code', at D.2.1.

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Ibid.

654

Ibid. at D.2.

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Ibid. at D.2.2.

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Ibid.

banks, for establishing disclosure and shareholder communication procedures,<sup>657</sup> see also the Financial Services (Banking Reform) Act 2013 and the Bank of England and Financial Services Act 2016.

Failure by a relevant director to ensure that the board/remuneration committee fixes affordable remuneration may show the director's unfitness and be a ground for a disqualification order.<sup>658</sup> The difficulties associated with ensuring that bank remuneration committees adequately undertake their responsibilities are immense. Among those responsibilities, there are two conflicting objectives of shareholder wealth maximisation and financial stability. Due to this, the remuneration committees of banks have to strike an appropriate balance between shareholder interest maximisation and avoidance of systemic risks inherent in remuneration arrangements, between risk appetite and risk controls, between short term and longer-term performance, and between individual business unit goals and firm-wide objectives. Company law has been weak in encouraging non-executive directors to balance shareholder interests with the wider public interests. It is argued that directors' fiduciary duty to promote the success of the company for the benefit of its shareholders as a whole, and in doing so have regard to stakeholder interests<sup>659</sup> may serve to encourage box-ticking and lip-service to the enlightened shareholder value factors.<sup>660</sup>

The Corporate Governance Code requires the remuneration committee to set remuneration with a significant proportion of a director's remuneration package being dependent on individual/corporate performance.<sup>661</sup> The FCA Remuneration Code requires the remuneration committee to set executive remuneration with salary being a sufficient proportion of total remuneration to allow bonuses to be fully flexible.<sup>662</sup> A careful balance is called for. The remuneration committee may face great difficulties in properly implementing the complex risk-based approach to executive remuneration adopted by the FSB Principles and FCA Remuneration Code, which focuses upon risk adjustment of executive remuneration, symmetry between remuneration and risk outcomes, and sensitivity to short- and long-term risk. It is required to design remuneration that takes into

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ABI, 'Executive Remuneration: Guidelines on Policies and Practices', (2009) at Section 1 Main Provisions.

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See *Secretary of State for Trade and Industry v Van Hengel* [1995] 1 BCLC 545.

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Companies Act 2006 (c.46), Section 172.

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R. Hollington, 'Directors' Duties under the Companies Act 2006 - Have the Lunatics Taken over the Asylum?', (2008).

661

FRC, 'The UK Corporate Governance Code', at D.1.

662

SYSC 19.3.17.



consideration all types of risk, that is, prospective risks and risk outcomes that are realised.<sup>663</sup> This difficulty may lead to unexpected side effects due to inaccurate risk-adjustment. Critics argue that imposing unduly extensive responsibilities on non-executive directors sitting on the remuneration committee may overly burden them and compromise the chief executive's ability to manage incentive structures for the whole management team.<sup>664</sup>

As required by the FCA, at least one member of the bank remuneration committee should have practical skills and experience of risk management.<sup>665</sup> It is accepted that the competence of bank remuneration committees can be further strengthened by inputs from risk and audit committees<sup>666</sup> and from outside of the board, for example multiple remuneration consultants and employee representatives. The Walker Review recommends that the remuneration committee should seek advice on an arms-length basis from the risk committee to prevent inappropriate incentives in performance measures.<sup>667</sup> Lord Myners has emphasised that remuneration committees need to have a substantial number of inputs and has argued that employees should be allowed to air their views on the understanding, that is, that only directors could make the actual decisions.<sup>668</sup> Some suggest improving the remuneration committee's competence by bringing employee representatives onto the committee.<sup>669</sup> It is argued that this approach may risk changing the structure and approach of the unitary board.<sup>670</sup> It may even risk compromising the remuneration committee's competence by effectively mixing the notion of social justice and wealth distribution into the committee's decisions, jeopardising the very purpose of bringing their views to the committee. An adequate regime of public disclosure as opposed to supervisory disclosure is essential in fixing the agency problems in the pay-setting process in banks and to supporting effective bank executive remuneration governance.<sup>671</sup> The board of directors of a publicly

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'FSF Principles for Sound Compensation Practices', at Principle 4.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.

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SYSC 19.3.2G(3).

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This recommendation has been implemented in SYSC 19.3.3E.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at 108.

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House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at para.74.

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Ibid. at para.73.

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Ibid.

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quoted bank is required to prepare, approve and publish both a directors' remuneration report, under Companies Act 2006 (c.46) (Sections 420, 421 and 422) and Regulations 2008 (SI 2008/410),<sup>672</sup> and an executives' remuneration report under the Financial Services Act 2010 (c.28).<sup>673</sup> These disclosure rules have their UK-specific historical background. In response to widespread concern about excessive remuneration in the then privatised utilities, the Greenbury Report of 1995 called for rather extensive reforms in executive remuneration disclosure, especially in respect of share options, thereby enabling investors to better understand the economic costs of equity grants.<sup>674</sup> Due to the continuing widespread dissatisfaction concerning the issue of directors' remuneration, especially over the levels of severance payments, often termed rewards for failure, the UK Government decided in 1999 that voluntary disclosure was no longer adequate or appropriate and mandatory disclosure was required.<sup>675</sup>

The Directors' Remuneration Report Regulations 2002 (SI 2002/1986) were introduced in the UK and were absorbed into the Companies Act of 2006. Quoted companies are required under the Companies Act 2006 (c.46) and Regulations 2008 (SI 2008/410) to publish a directors' remuneration report as part of the company's annual reports and to disclose within that report comprehensive details of each individual director's remuneration package. Information that should be disclosed in tabular form contains the total amount paid to or receivable from salary and fees, bonuses, expense allowance, compensation for loss of office and for termination of qualifying services, and non-cash benefits.<sup>676</sup> Regulations 2008 (SI 2008/410) requires disclosure of the company's remuneration policy, the role of the board and the membership and role of the remuneration committee.<sup>677</sup> In response to the shortcomings that emerged in the financial crisis in respect of bank executives' remuneration, a bank is required under the Financial Services Act 2010 (c.28) and draft

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BCBS, 'Consultative Document: Principles for Enhancing Corporate Governance', at Principle 14.

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Paragraphs 2(1) and 3-16 of Regulations 2008 (SI 2008/410) specify the form and content of information to be disclosed in the directors' remuneration report.

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For the definition of a publicly quoted bank, see Companies Act 2006 (c.46), section 385. UKLA Listing Rules, applicable only to a listed company incorporated in the UK, contain specific requirements in respect of remuneration-related information disclosure and shareholder approval. In specific, LR9.8.6R and LR9.8.8R specify the content of the remuneration-related information to be disclosed in addition to those required by the Companies Act 2006 (c.46), sections 420-22. LR 13.8.11R-13.8.15R detail the content and form of a circular to shareholders about the approval of, and amendments to, an employee's share scheme or long-term incentive scheme.

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M. Conyon and G. Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK', *Corporate Governance: An International Review*, 18/4 (2010), 296 at 297.

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DTI, 'Directors' Remuneration: A Consultation Document', (London: DTI, 1999).

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The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410), Schedule 8, Paragraphs 8-14.

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Ibid. Schedule 8, Part 2.

Regulations 2010 to disclose an executives' remuneration report. There is no need to duplicate information that is disclosed in the directors' remuneration report or in the accounts but, subject to that, the executives' remuneration report must disclose detailed information on an executives' remuneration policy with particular focus on risks and deference, a remuneration committee report with an explanation of compatibility with effective risk management, and the number of, and the aggregate amounts earned by, executives in each specified band.<sup>678</sup>

In terms of rationales, given the legitimate interest of stakeholders in the remuneration of bank directors and executives in order to independently gauge the bank's continued financial health and stability, comprehensive public disclosure is vital. It enables bank shareholders and other stakeholders to evaluate the linkage of executive remuneration to risk-adjusted long-term performance, to detect the extent to which a problem with bank executive remuneration exists, and to understand and take control of the agency costs associated with the two-tier principal-agent relationships. It may help curb certain types of inappropriate remuneration practices.<sup>679</sup> Disclosure can encourage bank executives and boards to reduce agency costs;<sup>680</sup> buttress board monitoring and independence by enhancing the board's ability to withstand the pressure coming from executives and directors;<sup>681</sup> and, by way of publicity dynamics, incentivise shareholders and stakeholders to take actions.<sup>682</sup> It can facilitate constructive engagement of the board with shareholders and other stakeholders.<sup>683</sup> Disclosure of remuneration information is, as a key indicator of bank corporate governance practices, valuable for the market and bank supervisors. It signals sound and safe remuneration practice to the market<sup>684</sup> and may strengthen all market forces aligning interests in the two-tier principal-agent relationships. It can be argued that the disclosure of confidential business information may be effectively prevented by means of exceptions and in practice performance measures using such information are relatively rare.<sup>685</sup>

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<sup>679</sup> The Executives' Remuneration Reports Regulations 2010, Schedule, Paragraphs 1-12.

<sup>680</sup> OECD, 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', at 22.

<sup>681</sup> A. Andjelkovic, G. Boyle, and W. Mcnoe, 'Public Disclosure of Executive Compensation: Do Shareholders Need to Know?', *Pacific Basin Finance Journal*, 10/1 (2002), 97.

<sup>682</sup> Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 85.

<sup>683</sup> Ibid.

<sup>684</sup> FSF, 'FSF Principles for Sound Compensation Practices', at 3.

<sup>685</sup> I.M. Ramsay, 'Directors and Officers' Remuneration: The Role of the Law', *Journal of Business Law*, 174/23 (1992), 351.

In view of the wide benefits of comprehensive disclosure and the belief that most of the information needed for disclosure has been collected in the pay-setting process, disclosure costs are arguably small. Inadequate and inaccurate disclosure can feed envy<sup>686</sup> and serve to camouflage remuneration,<sup>687</sup> misleading shareholders and stakeholders. Certainly, without clear and effective disclosure, the potential herd mentality of institutional shareholders and the market may become destructive.<sup>688</sup> It is acknowledged that the disclosure of remuneration information will not be effective without necessary disclosure of information on risk management and internal controls so as to allow stakeholders to gauge the robustness of support for a bank's strategy and risk appetite as well as to enable the bank's counterparties to make an appropriate decision on their business relations with the bank.<sup>689</sup> Disclosure must be made in a comprehensive, clear, accurate, and timely manner and allow for easy assessment of the pay-performance linkage and risk alignment. Effective and standardised disclosure can reduce information costs to institutional shareholders and other interested stakeholders, by sharpening shareholder engagement and stakeholder monitoring and focusing board attention more closely on inappropriate incentives that remuneration policies and arrangements may create.<sup>690</sup>

In order for bank stakeholders to gauge the bank's continued financial health and stability, disclosed information should be comprehensive and individualised to the level at which they can effectively evaluate the linkage of executive remuneration to risk-adjusted long-term performance. The auditable information in respect of the remuneration of bank executives immediately below board level is disclosed in aggregate fashion rather than individualised and only on the number of, and the aggregate amounts earned by them in each specified band. Among other things, auditable information on the remuneration of bank executives immediately below board level may be disclosed under the Regulations of 2010 in the way in which directors' remuneration is required to be disclosed under Regulations 2008<sup>691</sup>.

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For problems associated with the overly wide application of such exceptions under the Sarbanes-Oxley-Act, see M.D. Mobley, 'Compensation Committee Reports Post-Sarbanes-Oxley: Unimproved Disclosure of Executive Compensation Policies and Practices', *Columbia Business Law Review*, 1/3 (2005), 111 at 130.

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M.C. Jensen and K. Murphy, 'CEO Incentives - It's Not How Much You Pay, but How', *Harvard Business Review*, 68/3 (1990), 138 at 144.

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L.A. Bebchuk and J.M. Fried, 'Stealth Compensation Via Retirement Benefits', *Berkeley Business Law Journal*, 1/2 (2004b), 291 at 299.

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Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 88.

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FSF, 'FSF Principles for Sound Compensation Practices', at 3.

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Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 86.

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These 2010 Regulations may require an individualised disclosure of auditable information on bonuses of executives immediately below board level. A non-auditable individualised explanation may be provided concerning the way in which each bank executive director's remuneration performance criteria are linked to the bank's long-term interests and risks. The regime may require a sufficiently detailed description of the manner of risk adjustment as required by the FSF Principles.<sup>692</sup> It is reasonable that banded disclosure should be accompanied by an analysis that gives stakeholders and the market an understanding of how remuneration is divided across business segments, presuming that those exposed to greater risk would have greater remuneration.<sup>693</sup> It is recognised that unduly onerous disclosure requirements may have detrimental effects, such as driving talented executives and senior traders away.<sup>694</sup> Requirements should be nuanced to be proportional to the size, complexity, structure and risk profile of different banks.

Disclosure itself may contribute to the ratcheting-up of pay due to common labour market practice.<sup>695</sup> Disclosure policy and regulation must be nuanced, clear and effective if it is to avoid, or at least effectively ameliorate, this side-effect. The government outlined new proposals to strengthen corporate governance, including measures designed to reduce excessive executive pay and make large privately-owned businesses meet the same standards as listed firms.<sup>696</sup>

### **Mandated advisory shareholder vote and shareholder empowerment**

In the UK, directors' and executives' remuneration reports of a publicly quoted bank are subject to an advisory, non-binding ordinary resolution at the bank's annual general meeting, with no entitlement of a director or an executive to remuneration being made conditional on the resolution being passed.<sup>697</sup> This mechanism complements compulsory shareholder approval requirements. Where shareholder agreement is required for a change in remuneration policy, such as the introduction of, or material amendment to, employees share schemes, long-term incentive plans or discounted option arrangements,<sup>698</sup> specific prior

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<sup>693</sup> FSF, 'FSF Principles for Sound Compensation Practices', at 14.

<sup>694</sup> Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at

<sup>695</sup> Ibid. at para.7.11.

<sup>696</sup> Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 89.

<sup>697</sup> The Wall Street Journal, Nov 29 2016, 'UK Proposals Aim to strengthen Corporate Governance'.

<sup>698</sup> Companies Act 2006 (c.46), Section 439. Draft Executives' Remuneration Reports Regulations 2010, Section 14.

Listing Rules, LR 9.4. With respect to long-term incentive plans, only those in which directors participate are subject to shareholder approval.

approval by an ordinary resolution of shareholders in a general meeting is sought. These requirements do not aim at controlling executive remuneration but at protecting the rights attached to existing shares from dilution.<sup>699</sup> The provisions of the Companies Act 2006 (c.46) specify that shareholder approval is required for any exceptional payments to a director on loss of office<sup>700</sup> and for a guaranteed term of employment for more than two years.<sup>701</sup> Whilst the compulsory vote on option and share reward schemes covers important remuneration components which are susceptible to poor design, this is not sufficient. Second, say on pay offers a flexible and non-interventionist way in which shareholders can influence boards on remuneration matters where they may have legitimate concerns.<sup>702</sup> It is argued that a high level of shareholder approval in UK companies since the introduction of the mandated advisory vote mechanism in 2002<sup>703</sup> may indicate effective shareholder influence over board behaviour.<sup>704</sup>

Critics may call the mandated advisory shareholder vote mechanism a hybrid with an unclear legal effect.<sup>705</sup> It is argued that its strength does not lie with legal force but derives from the market force associated with the voice mechanism conferred upon shareholders. Evidence shows that board decision-making is influenced by the prospect of a mandated advisory shareholder vote and boards tend to respect the result of the advisory vote.<sup>706</sup> This mechanism may encourage boards to actively consult with major shareholders on sensitive remuneration matters.<sup>707</sup> With appropriate disclosure, it may help reduce the equity

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Productivity Commission, 'Executive Remuneration in Australia', at 289.

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Companies Act 2006 (c.46), Section 217.

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Ibid. Sections 188, 189. *Wright v Atlas Wright (Europe) Ltd* [1999] 2 BCLC 301 at 314.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.7.38.

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Canyon and Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK'. (finding that less than 10 per cent of shareholders abstain or vote against the mandated directors' remuneration report resolution in the period from 2002 to 2007.)

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J.N. Gordon, "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In', *Harvard Journal of Legislation*, 46/2 (2009), 323 at 341.

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K.J. Hopt, 'Modern Company and Capital Market Problems - Improving European Corporate Governance after Enron', ECGI Working Paper No.05/2002 (Hamburg, 2002) at 12.

706

G. Ferrarini and N. Moloney, 'Executive Remuneration in the EU: The Context for Reform', *Oxford Review of Economic Policy*, 21/2 (2005), 304 at 11.

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governance problems by way of strengthening the independence of a board remuneration committee.<sup>708</sup> Because institutional shareholders may react strongly to outlier executive remuneration arrangements, which do not conform to shareholder-friendly best practice,<sup>709</sup> this mechanism may facilitate the implementation of shareholder-friendly best practice on bank executive remuneration. With regard to UK executive remuneration, there is evidence that advisory shareholder voting may be an effective mechanism to reduce alleged egregious executive remuneration arrangements from the perspective of shareholders;<sup>710</sup> that shareholders disapprove of higher salaries, weak pay-for-performance sensitivity in bonuses, and greater potential dilution from share-based remuneration;<sup>711</sup> and that it effectively puts to an end the UK version of the golden parachute, i.e. long-term executive employment contracts, with almost no large UK companies entering into senior executive contracts of more than one year or providing for accelerated share options upon a change in control.<sup>712</sup> The shortening of executives' contract periods to one year or less may cause executives to feel less secure and become more opportunistic and inclined to take higher risk. An advisory shareholder vote is not without downsides even from the perspective of shareholders. It does not require prompt adjustments to inappropriate remuneration arrangements in the current financial year.<sup>713</sup> Its effect over the level and design of executive remuneration may be limited.<sup>714</sup> Since disclosure is an essential part of an advisory vote, a company with a no vote may attribute the no vote to not clearly explaining and justifying its remuneration policy to shareholders. It may lead to the one size fits all and box-ticking approach by shareholders to executive remuneration, resulting in a homogeneity in executive remuneration practices and

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J.L. Ossinger, 'Regarding CEO Pay, Why Are the British So Different?', Wall Street Journal (2006) at R6. (documenting that 200 firms annually consult with ABI.)

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Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 23. OECD, 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', at 24.

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J.G. Hill, 'New Trends in the Regulation of Executive Remuneration', European Corporate Governance Institute Law Working Paper No. 142/2010 (2010) at 39.

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Canyon and Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK'.

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M.E. Carter and V. Zamora, 'Shareholder Remuneration Votes and CEO Compensation Design', AAA 2008 MAS Meeting Paper (2007).

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Deloitte, 'Report on the Impact of the Directors' Remuneration Report Regulations: a Report for the Department of Trade and Industry', (2004) at 6, 19-20.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.7.40.

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Canyon and Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK'.

the suppressing of value-enhancing innovative remuneration structures,<sup>715</sup> attributable in part to the role of proxy advisors. Few negative recommendations from proxy advisors over the period of 2003 to 2007 may contribute to the fact that only 9 say-on-pay resolutions in UK companies were rejected between 2003 and 2009.<sup>716</sup>

Mandated voting for shareholders eliminates the barrier of the initial impulse. The technical work is undertaken by the remuneration committee, with the assistance of professional advisors. The publication of the details of remuneration policies and arrangements, necessary for a mandatory advisory shareholder vote, reduces rational apathy due to the costs of obtaining information.<sup>717</sup> Shareholders may make uninformed decisions because of insufficient expertise. General disclosure can help to establish benchmarks. A vote can involve all shareholders whilst the costs to the individual are marginal.<sup>718</sup> Votes can either concern remuneration policies prospectively or remuneration reports retrospectively.<sup>719</sup> A shareholder vote on remuneration policies only accommodates privacy concerns.<sup>720</sup> It is important for shareholders to express views on how a remuneration policy is applied in practice.

The fact that large remuneration packages were received by executives and senior traders of banks which thereafter collapsed or survived only through government bailouts has energised shareholder empowerment supporters. Some propose a binding shareholder resolution in respect of the remuneration report as a whole.<sup>721</sup> The Walker Report argues that it is difficult to implement such a proposal.<sup>722</sup> Binding votes can create problems with

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Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 87.

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Gordon, "'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In', at 329.

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Bebchuk and Fried, 'Pay without Performance: The Unfulfilled Promise of Executive Compensation', at 207.

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For counterarguments, see L. Roach, 'The Directors' Remuneration Report Regulations 2002 and the Disclosure of Executive Remuneration', *Company Lawyer*, 25/5 (2004), 141 at 141, 44.

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DTI, 'Directors' Remuneration: A Consultation Document', at para.2.24.

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This was considered positive by the Department of Trade and Industry. *Ibid.*

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The European Commission's 2004 Recommendation on Directors' Remuneration [2004] OJ L385/55 allows a binding vote, and there are countries with binding votes, e.g. Netherlands, Sweden, Norway and Denmark. See J.R. Delman, 'Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation', *Columbia Business Law Review*, 2010/2 (2010), 583 at 592-93.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', at para.7.38.



contractual entitlements negotiated and approved beforehand within the framework of a specific policy implicitly or explicitly approved by shareholders.<sup>723</sup> Qualified executives may avoid jurisdictions subjecting them to uncertainties of provisional contracts. But certain remuneration components based upon share issues are subjected to binding shareholder approval in the UK without insuperable practical difficulties.<sup>724</sup> The Walker Report instead proposes that if fewer than 75 percent of the votes are cast on resolutions by remuneration committees then its chairman should be obliged to stand for re-election at the next AGM regardless of the time left on his term.<sup>725</sup> This proposal seems designed to help mitigate the equity governance problems in the context that remuneration policies have attracted enormous shareholder concerns, together with wider political and media attentions. Paul Myners, the UK's City minister, goes further and suggests giving bank shareholders mandatory power to vote on individual remuneration arrangements before they are approved.<sup>726</sup> Franks instead favours indirect regulation that makes it easier for shareholders to nominate directors in tackling bank remuneration problems. This is rejected by Montagnon, as he argues that this may undermine the proper functioning of the unitary board.<sup>727</sup>

There is still room for improvement in terms of say on pay. This is reflected in the case of the disputed pension award by the RBS board to its former chief executive, Sir Fred Goodwin.<sup>728</sup> Aligned with the view expressed by shareholders that no executive board member who leaves early should have a contractual right to retire on full pension, the UKFI, RBS's biggest shareholder, rejected RBS's 2008 remuneration report at its annual shareholder meeting in protest over its controversial pension award. The formal shareholder rebuke had no legal effect upon his £703,000 annual pension and his employment contract meant RBS was legally obliged to pay him a full pension if he had been asked to leave the company early.<sup>729</sup> These proposed reforms do not adequately address the excessive risk-

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DTI, 'Rewards for Failure': Directors' Remuneration - Contracts, Performance and Severance', (London: DTI, 2003) at para.3.15.

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Listing Rules, LR 9.4.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at para.7.23.

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P.T. Larsen, 'Shareholders Can't Do Board's Work on U.K. Bank Bonuses', Reuters (2010).

727

Select Committee on Economic Affairs, 'Banking Supervision and Regulation - Volume I: Report', (London: SCEA, 2009b) at para.198.

728

N. Myles, 'Government against RBS Pay Plans', Reuters (2009).

729

Ibid.

taking nature of bank executive remuneration arrangements. Shareholder empowerment cannot be relied upon to address inappropriate incentives that create or exacerbate systemic risks. There is evidence that bank shareholders in the UK failed to exercise effective control over remuneration policies so as to prevent excessive risk-taking or activities inconsistent with corporate wellbeing.<sup>730</sup> On the contrary, shareholder empowerment would give an air of legitimacy to systemic risk-free remuneration structures at banks. In terms of the link between pay and long-term performance, risk policies and system advocated in the Corporate Governance Code,<sup>731</sup> undue promotion of shareholder empowerment may do more harm than good if problems such as short-termism, widely exhibited in the market, are not properly resolved.<sup>732</sup>

During the five-year period, growth in UK banks continued based on high-powered incentives with bonuses for bank executives accounting for at least a third of their total remuneration packages. The remuneration structures for investment bankers were more centred on incentives, which allowed bankers to pocket 50% of trading revenues generated.<sup>733</sup> UK bank shareholders were content with aggressive risk-taking fostered by high-powered incentives. This is not surprising since they were doing very well from it. Over the five-year period from 2003 to 2007, FTSE 350 Banks index (NMX8350)<sup>734</sup> increased by more than 80% from 6500 to 11800. This equated to a 16% annualised return. An increasing percentage of shareholdings at banks were held by hedge funds<sup>735</sup> which tended to demand even higher returns, usually at the cost of future profitability and stability, than conventional institutional shareholders such as insurance companies, banks and pension funds. As Ferrarini et al. observe, it appears that the mandated advisory vote brought about widespread approval of remuneration policies in real terms and more increases in remuneration. Only eight rejections were logged from 2002 to mid 2009, and no rejections

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House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at paras.61-68.

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FRC, 'The UK Corporate Governance Code', at D1 and Schedule A.

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Walker, 'The Challenge of Improving the Long-Term Focus of Executive Pay'.

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J. Treanor, 'Barclays to Reignite Bonus Row with £2.3bn Payout to Investment Bankers', The Guardian (2010).

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<http://www.findata.co.nz/markets/lse/nmx8350/chart.htm>.

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The two largest shareholders of Northern Rock in 2007, RAB Capital and SRM Global, were hedge funds that accounted for 13% of the bank's equity.

were made over bank executive remuneration.<sup>736</sup> As the Walker Report observes,<sup>737</sup> before the banking crisis broke out, there appeared to have been a widespread shareholder consent in the increasing expansion and leverage<sup>738</sup> of banks' balance sheets in order to boost ROE. Some major fund managers appeared to have been slow to act where problems in investee banks were identified, and rarely sought to fix them. A Treasury Select Committee report comes to a similar conclusion.<sup>739</sup>

Even if bank shareholders have incentives to oversee systemic risks generated by executive remuneration, they do not seem to be capable of appropriately gauging systemic risks because these are generated at the level of the interlinking and complex financial system and are hard to detect at bank level.<sup>740</sup> Systemic risks accumulate in the form of safe financial instruments and products, which makes it difficult to argue, if not in retrospect, that these risks have exceeded the pre-set risk tolerance level. Last but not least, in terms of the design of the mandatory advisory shareholder vote mechanism, it is an approach reliant on the self-interest of shareholders as a means of validating the board's power over senior officer compensation and of mitigating concerns that executive remuneration arrangements are not designed in the shareholders' best interests.<sup>741</sup> It has been devised to address the conflicts of interest between executives, the board and shareholders rather than to induce the board to take into consideration the interests of stakeholders.<sup>742</sup> It is used to improve the linkage between pay and performance, to empower shareholders and improve shareholder democracy, to give greater focus to remuneration committees when carrying out their duties as custodians of shareholder interests, and to encourage shareholders to take a more holistic view on remuneration.

With the possibility of the market being driven by short-termism, it is doubtful whether shareholder empowerment per se can effectively address the issue of short-termism so as to

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Ferrarini, Moloney, and Ungureanu, 'Executive Remuneration in Crisis: A Critical Assessment of Reforms in Europe', at 88.

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Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities (Consultation Document)', at 62.

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Ladipo and Nestor, 'Bank Boards and the Financial Crisis: A Corporate Governance Study of the 25 Largest European Banks', at 88-9.

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House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at para.68.

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FSA, 'The Turner Review: A Regulatory Response to the Global Banking Crisis'.

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Canyon and Sadler, 'Shareholder Voting and Directors' Remuneration Report Legislation: Say on Pay in the UK', at 296.

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Delman, 'Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation', at 585.

strengthen the linkage of pay to long-term performance and risk policies and system. It is argued that short-term focused remuneration arrangements are reflections of myopic investor preferences.<sup>743</sup> Shareholders do not want executives to focus upon the long term any more than they already do. Samuelson and Stout argue that institutional and individual investors have both become concerned with quarterly earnings forecasts and short-term share price changes.<sup>744</sup> Empirical evidence regarding the existence of market myopia is mixed. It has been suggested that the growth of private equity buyouts, which free companies from focusing upon long-term gains, is some evidence of market myopia.<sup>745</sup> Others point to positive stock market reaction to long-term investment as evidence against market myopia.<sup>746</sup>

## Stakeholder involvement

Regulations 2010 fails to provide debenture holders with an effective channel for stakeholder voice to counter-balance shareholders' risk-shifting self-interest but leaves it solely to market forces. This leads to doubts about the practical effectiveness of this requirement. The FCA's regulation, supervision and enforcement in respect of bank executive remuneration. Rather, regulation of remuneration governance complements direct regulation of remuneration contents and is more flexible and less susceptible to over-regulation than is direct regulation of remuneration contents. A draconian regulatory intervention in executive remuneration at banks may lead to an unhealthy homogeneity in remuneration practices, stifle innovation and beneficial risk-taking.<sup>747</sup> It may disincentivise the board/remuneration committee from actively taking responsibility for assessing the link between pay and long-term performance<sup>748</sup> and between pay and effective risk-management. They may lead to banks employing talented lawyers to find ways to circumvent complex and onerous rules. Where a system is based upon principles, avoidance becomes far more difficult. The principles-based approach has its own shortcomings, one of which is that it may lead to complacency and an unduly light-touch regulation and supervision in the boom years.<sup>749</sup> In

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For market and managerial myopia, see Stein, 'Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behaviour', at 655. B. Cadman and J. Sunder, 'The Role of Investor Horizon on Compensation Horizon', (2009).

<sup>744</sup>

J.F. Samuelson and L.A. Stout, 'Are Executives Paid Too Much?', Wall Street Journal (2009) at C1.

<sup>745</sup>

M. Kahan and E.B. Rock, 'Hedge Funds in Corporate Governance and Corporate Control', University of Pennsylvania Law Review, 155/5 (2007), 1021.

<sup>746</sup>

M.C. Jensen, 'The Takeover Controversy: Analysis and Evidence', in J.M. Stern (ed.), Corporate Restructuring and Executive Compensation (World Bank Atlas, 1989).

<sup>747</sup>

Matthews and Matthews, 'Controlling Bankers' Bonuses: Efficient Regulation or Politics of Envy?', at 73.

<sup>748</sup>

OECD, 'Corporate Governance and the Financial Crisis: Key Findings and Main Messages', at 26.

<sup>749</sup>

terms of supervision, the FCA has included remuneration practices in their risk assessment of banks.<sup>750</sup> As the FSB argues, a supervisory review of remuneration practices should be meticulous and uninterrupted, with any weaknesses being dealt with swiftly.<sup>751</sup>

Apart from conventional enforcement tools, the FCA has been given express powers to prohibit a bank from remunerating its staff in a specific way, to render void any provision of an agreement that contravenes such a prohibition and to provide for the recovery of payments made, or property transferred, in pursuance of a void provision.<sup>752</sup> It is recognised, as the FCA claims, that these powers will only be of use where the effect of the prohibition can be seen before they are applied.<sup>753</sup> In acknowledgement of that, the FCA proposed to limit this power to deferral arrangements and guaranteed bonuses.<sup>754</sup> As the FCA states, where a coherent case has been put forward that the voiding powers of banks apply to a specific contract it will be forced to recover any payments made or property transferred.<sup>755</sup> Banks would be denied from granting variable remuneration components to executives unless a legal advice assures that the grant complies with the Remuneration Code.<sup>756</sup>

US banking regulators, such as the FDIC, have long been actively disputing unsafe and unsound remuneration practices.<sup>757</sup> The types of incentive remuneration arrangements which FDIC has targeted include: remuneration arrangements of loan officers to incentivise them to underwrite loans without regard for their credit quality;<sup>758</sup> and the termination provisions of a

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House of Commons Treasury Committee, 'Banking Crisis: Reforming Corporate Governance and Pay in the City', at 37.

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FSA, 'Reforming Remuneration Practices in Financial Services: Feedback on CP09/10 and Final Rules'.

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FSF, 'FSF Principles for Sound Compensation Practices', at 3.

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Financial Services Act 2010 (c.28), Section 6.

753

FSA, 'Revising the Remuneration Code', (CP10/19; London: FSA, 2010c) at para.3.106.

754

Ibid.

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Ibid.

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Ibid.

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H.M. Schooner, 'Who Determines When Enough Is Enough? Refocusing Regulatory Limitations on Banks' Compensation Practices', Boston College Law Review, 37/5 (1996), 52 at 871.

758

Ibid.

remuneration contract which do not allow the bank to terminate the employee's remuneration for failure to perform. The enforcement cases are based on the excessive claims that the remuneration paid impacted the bank's capital or liquidity, i.e. its financial condition.<sup>759</sup> The FDIC in some cases did not explicitly consider whether or not a remuneration arrangement was excessive but was concerned that the large remuneration arrangement may undermine the public's confidence.<sup>760</sup> The trade-off for the FCA in relation to bank executive remuneration is to balance financial stability with the need to preserve the banking sector in its role as an important contributor to the economy<sup>761</sup> and the banking sector's need to attract and retain talented executives. This argues that the FCA's attention should be directed at the underlying causes of inappropriate remuneration, i.e. the two-tier agency problems. Direct regulation of the structure of executive remuneration arrangements and the use of the FCA's veto power have the advantage of potentially shifting the decision-making function away from self-interested directors and the influence of executives and placing it in the hands of the FCA.

A bank's need to attract, motivate and retain talented executives is arguably most crucial when the bank is under financial stress, whilst executives concurrently have the greatest incentive to seek employment elsewhere. This paradox sets the FCA's heightened supervision and instinct to intervene against the bank's need to maintain maximum flexibility during crisis management. It is unrealistic to believe that the FCA's requirements on remuneration practices can be reconciled with the bank's pending needs. The FCA's intention is not to threaten the long-term viability of healthy banks.<sup>762</sup>

### **Corporate governance reforms**

Corporate governance reforms have concentrated on the following: strengthening the role and function of the board of directors; strengthening the independence and the role of market intermediaries, including the oversight of auditors, credit rating agencies, market analysts and IPO sponsors; improving the quality and integrity of public disclosure to provide more transparency and strengthening the ability of investors to take care of their interests. Corporate governance problems differ in various parts of the world. Having enough independent oversight to deal with corporate governance problems of state-led companies is

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<sup>759</sup>

Ibid.

<sup>760</sup>

Ibid.

<sup>761</sup>

FSA, 'Revising the Remuneration Code', at A2:3.

<sup>762</sup>

The FSA does not intend to remove from the banking sector, as a means to achieve a competitive edge, the free market for human capital. For these reasons, the FSA must exercise caution in exercising its veto power and direct regulation over remuneration practices at both healthy and ailing banks.

another common challenge. Improved transparency resulting from better corporate governance practices means shareholders are better able to exercise ownership function.<sup>763</sup>

Regulators and governments having instituted regulations and structures designed to promote good corporate governance must guard against complacency and strengthen enforcement efforts to improve standards. Markets are an intersection of supply and demand. The supply of good corporate governance practices by management must match the investor demand for better practices, as well as the transparency of performance. To conclude, the regulators have to work out an infrastructure that promotes good corporate governance and to enforce breaches of the relevant rules or regulations, but the delivery of performance and the willingness to conform to best practices must come from the drive and action of good corporate management. It appears that Sarbanes-Oxley in the US does not appear to be able to deter corporate governance flaws in banking and in addition, the CA 2006 and the corporate governance codes appear not to work too much in the UK and this is why updated corporate governance were launched in the UK and this is also why Dodd-Frank came about after it.

### **Dodd–Frank Wall Street Reform and Consumer Protection Act (US and UK regulatory responses to the 2007 global financial crisis)**

After the 2007 global financial crisis, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into federal law by president Barack Obama on July 21, 2010 in Washington, DC.<sup>764</sup> Passed as a response to the 2000s recession, it brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the great depression.<sup>765</sup> It made changes in the American financial regulatory environment that affect all federal financial regulatory agencies and almost every part of the nation's financial services industry.<sup>766</sup> As with other major financial reforms, a variety of critics have attacked the law, some arguing it was not enough to prevent another

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Improved transparency is important for emerging markets because of the higher risk of expropriation of minority shareholders' wealth and abuse of minority shareholders' rights.

<sup>764</sup>

"Bill Summary & Status – 111th Congress (2009–2010) – H.R.4173 – All Information – THOMAS (Library of Congress)". (<http://thomas.loc.gov/cgi-bin/bdquery/z?d111:HR04173:@@L&summ2=m&#major%20actions>) Library of Congress.

<sup>765</sup>

"Historic financial overhaul signed to law by Obama" ([http://news.yahoo.com/s/ap/20100721/ap\\_on\\_bi\\_ge/us\\_financial](http://news.yahoo.com/s/ap/20100721/ap_on_bi_ge/us_financial)). Yahoo! News. Paletta, Damian; Lucchetti, Aaron. "Senate Passes Sweeping Finance Overhaul". (<http://online.wsj.com/article/SB10001424052748704682604575>) Wall Street Journal.

"Obama to Sign Dodd–Frank Financial Regulatory Reform Bill Into Law Today" (<http://washingtonindependent.com/92161/obama-to-sign-dodd-frank-financial-regulatory-reform-bill-into-law-today>). The Washington Independent.

<sup>766</sup>

"Dodd–Frank Act Becomes Law" (<http://blogs.law.harvard.edu/corpgov/2010/07/21/dodd-frank-act-becomes-law/>). The Harvard Law School Forum on Corporate Governance and Financial Regulation.

financial crisis or more bail outs, and others arguing it went too far and unduly restricted financial institutions.<sup>767</sup> The law was proposed by the Obama Administration in June 2009, when the White House sent a series of proposed bills to Congress. A version of the legislation was introduced in the House in July 2009. On December 2, 2009, revised versions were introduced in the house of representatives by Financial Services Committee Chairman Barney Frank, and in the Senate Banking Committee by Chairman Chris Dodd. Due to their involvement with the bill, the conference committee that reported on June 25, 2010, voted to name the bill after the two members of Congress.<sup>768</sup> The financial crisis of 2007–2010 led to widespread calls for changes in the regulatory system.<sup>769</sup> In June 2009, President Obama introduced a proposal for a sweeping overhaul of the United States financial regulatory system, a transformation on a scale not seen since the reforms that followed the Great Depression.<sup>770</sup>

As the finalized bill emerged from conference, President Obama stated that the bill included 90 percent of the proposals.<sup>771</sup> Major components of Obama's original proposal, listed by order in which they appear in the "A New Foundation" outline, include: the consolidation of regulatory agencies, elimination of the national thrift charter, and new oversight council to evaluate systemic risk; comprehensive regulation of financial markets, including increased transparency of derivatives; consumer protection reforms including a new consumer protection agency and uniform standards for plain vanilla products as well as strengthened investor protection; tools for financial crises, including a resolution regime complementing the existing Federal Deposit Insurance Corporation authority to allow for orderly winding down of bankrupt firms, and including a proposal that the Federal Reserve receive authorization from the Treasury for extensions of credit in unusual or exigent circumstances; various measures aimed at increasing international standards and cooperation including proposals related to improved accounting and tightened regulation of credit rating agencies. At Obama's request, Congress later added the Volcker Rule to this proposal in January 2010.<sup>772</sup>

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"The Dodd–Frank Act: Significant Impact on Public Companies" (<http://www.skadden.com/content/Publications/Publications21>) (PDF). Skadden, Arps, Slate, Meagher & Flom.

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Michael Simkovic, Competition and Crisis in Mortgage Securitization (<http://ssrn.com/abstract=1924831>)

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Paletta, Damian "It Has A Name: The Dodd/Frank Act" (<http://blogs.wsj.com/washwire/2010/06/25/it-has-a-name-the-doddfrank->

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Ewing, Jack. The New York Times [http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit\\_crisis/](http://topics.nytimes.com/topics/reference/timestopics/subjects/c/credit_crisis/)

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Initial speech: Obama B. Remarks by the President on 21st Century Financial Regulatory Reform

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Obama B. Remarks by the President on Wall Street Reform (<http://www.whitehouse.gov/the-press-office/remarks-president-wall-street-reform-1>). White House.

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The 2008 financial crisis will be known as the modern financial system's annals horribilis. A natural consequence of a crisis is that citizens are asking how this happened and who is to blame.<sup>773</sup> This invites the enquiry that amidst this wreckage, as legislators consider proposals for sweeping regulatory reforms, prosecutors and regulatory agencies have begun the arduous and time-consuming process of determining whether any criminal wrongdoing led to the credit crisis.<sup>774</sup> The introduction to Dodd-Frank makes clear what the legislation's intentions to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end too big to fail, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.<sup>775</sup> One particular aspect of Dodd-Frank, the Volcker Rule, which prohibits a bank from engaging in proprietary trading, and from acquiring or retaining an ownership interest in a hedge fund or private equity fund.<sup>776</sup> The intent of the Volcker Rule was to endeavour to replicate the US Banking Act of 1933, called the Glass Steagall Act after its sponsors, which separated investment banking from retail banking by limiting the range and volume of securities-related transactions that the commercial entities could perform.<sup>777</sup> This rule does not merely affect US entities but also applies to foreign banks and entities which have a branch or agency in the US and demonstrates the reach of US legislation.<sup>778</sup> An additional outcome of the review of the financial crisis was that the SEC recognised that more information on breaches of securities law was required and has caused it to promote the role of the whistleblower.<sup>779</sup> Dodd-Frank encourages whistleblowers to report suspected violations direct to the SEC Office of the Whistleblower,<sup>780</sup> which will

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Obama on the Volcker Rule: Cho, D; Appelbaum, B (January 2010). "Obama's 'Volcker Rule' shifts power away from Geithner"(<http://www.washingtonpost.com/wp-dyn/content/article/2010/01/21/AR2010012104935.html>). Washington Post.

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Ceresney, Eng and Nuttall (n 63) 225.

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Ceresney, Eng and Nuttall (n 63) 225.

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'Dodd-Frank Wall Street Reform and Consumer Protection Act.' Preamble. <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf> .

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The Dodd-Frank Wall Street Reform and Consumer Protection Act 2010, s 619.

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Baber (n 131) 237.

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William E Stern, 'Impact of the Volcker rule and related Dodd-Frank Act requirements on fund sponsors affiliated with non-US banking organisations' (2013) 4 JIBFL 229.

779

'Means any individual, or 2 or more individuals acting jointly, who provides information relating to a violation of this Act to the Commission, in a manner established by rule or regulation by the Commission' Dodd-Frank Act 2010, s 748(7).

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reward<sup>781</sup> such suppliers of information who are eligible to receive between 10 percent and 30 percent of any enforcement penalty in excess of \$1 million that the agency recovers as a result of the report.<sup>782</sup> The largest reward was \$30m in 2014.<sup>783</sup> Dodd-Frank was not the first attempt at encouraging informers to come forward with information about fraud against the government in return for a share of the damages recovered.<sup>784</sup> In 1863, pre-dating both conspiracy to defraud (1867) and Mail Fraud (1872), the False Claims Act empowered citizens to sue on behalf of the government for fraud against the government and share in the fruits of litigation since 2009, the DoJ has recovered more than \$13.3 billion in False Claims Act cases.<sup>785</sup> In 2012, the DoJ brought an all-time high of 647 whistleblower cases,<sup>786</sup> demonstrating the economic value of an incentivised whistleblower. The rewards from SEC make it all the more likely that employees who notice such wrongdoing will take steps to bring it to light. This may be at the expense of reporting through companies' internal corporate risk management or governance channels. The SEC reported receiving one to two high value tips per day, up from about a dozen a year prior to enactment' of Dodd-Frank.<sup>787</sup> There is the risk of repeat bad faith claims as in a 2014 case where the SEC banned an individual who had knowingly made 196 award applications which were false, fictitious or fraudulent in pursuit of an award.<sup>788</sup>

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US Securities and Exchange Commission, 'Speech by SEC Chairman: Opening Statement at SEC Open Meeting: Whistleblower Program' 25 May 2011. <http://www.sec.gov/news/speech/2011/spch052511mls-item2.htm> .

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'In addition to providing qualifying whistleblowers with a bounty, the Dodd-Frank Act protects whistleblowers in two other respects. First, it allows whistleblowers to remain anonymous up to the point of receiving their financial awards. Second, the Dodd-Frank Act allows whistleblowers to redeem their bounties unless they are convicted of a crime related to the reported FCPA violations' Hansberry (n 16) 195.

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Hansberry (n 16) 195. Welu (n 11). Robert S Bennett, Hilary Holt LoCicero and Brooks M Hanner, 'From Regulation to Prosecution to Cooperation: trends in Corporate White Collar Crime Enforcement and the Evolving role of the White Collar Criminal Defense Attorney', (2013) 68 The Business Lawyer 411.

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Securities and Exchange Commission, 'SEC Announces Largest-Ever Whistleblower Award' [\$30m]. <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543011290#.VCktK77HthY> .

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Carr (n 37)

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Department of Justice, 'Justice Department Recovers , Billion in False Claims Cases in Fiscal Year 2009; More Than \$24 Billion Since 1986' 19 November 2009. <http://www.justice.gov/opa/pr/2009/November/09-civ1253.html> .

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Department of Justice, 'Accomplishments under the leadership of Attorney General Eric Holder' (n 141).

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Hansberry (n 16) 195.

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Securities and Exchange Commission, 'Final Order' <http://www.whistleblowerdefense.com/files/2014/06/Final-Order7.pdf> .

The effect of Dodd-Frank is clear that the US has a long history of providing incentives. This is not a feature of UK culture and legislation, including the UK Bribery Act 2010, does not provide for these rewards.<sup>789</sup> The UK regulators FCA/PRA have announced proposals to make regulatory changes necessary to require firms to have effective whistleblowing procedures, and to make senior management accountable for delivering these,<sup>790</sup> but concluded that financial incentives to report would not be adopted.<sup>791</sup> This area is outside the scope of this thesis but would warrant further research because of the risk of regulatory arbitrage where, for UK companies falling within the purview of the SEC, whistleblowers may be tempted to report wrongdoing in the US rather than either the UK authorities or through internal procedures, where no rewards exist.<sup>792</sup>

Some years before Dodd-Frank, in the wake of a spate of financial / accounting scandals,<sup>793</sup> Sarbanes-Oxley Act 2002 was enacted to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.<sup>794</sup> This was a Congressional response to revelations of several high profile accounting fraud cases including Enron, WorldCom, Tyco, that resulted in mass destruction of investor value and loss of investor confidence in the integrity of the financial markets.<sup>795</sup> As Yeager notes, these cases led to criminal charges of company officials and the bankruptcy of Arthur Andersen LLP, at the time arguable the most prestigious independent auditing firm in the world.<sup>796</sup> A feature of Sarbanes-Oxley was increased sentences: the maximum penalty for wire and mail fraud from five years to twenty years imprisonment. Then, we will examine the financial crisis of 2007-2008.

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Chris Warren-Smith, 'Regulatory: The year ahead' (2011) 161 NLJ 358.

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Financial Conduct Authority, 'Financial Incentives for Whistleblowers. Note by the Financial Conduct Authority and the Prudential Regulation Authority for the Treasury Select Committee' <http://www.fca.org.uk/static/documents/financial-incentives-for-whistleblowers.pdf>.

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Financial Conduct Authority, 'Financial Incentives for Whistleblowers' (n 157).

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Hansberry (n 16) 195.

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For example Enron, Worldcom, Tyco, Arthur Andersen. Fred Yeager and others, 'US legislation designed to improve corporate governance: an exploration' (2010) 33(1) Co Law 25.

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Sarbanes-Oxley Act of 2002. Preamble. <http://www.sec.gov/about/laws/soa2002.pdf>.

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Yeager (n 150) 25.

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Yeager (n 150) 25.

## Financial crisis of 2007–2008

The financial crisis of 2007–2008, also known as the global financial crisis and the 2008 financial crisis, is considered by many economists to have been the worst financial crisis since the Great Depression of the 1930s.<sup>797</sup> It began in 2007 with a crisis in the [subprime mortgage](#) market in the US, and developed into a full-blown international [banking crisis](#) with the collapse of the investment bank Lehman Brothers on September 15, 2008.<sup>798</sup> Excessive risk-taking by banks such as Lehman Brothers helped to magnify the financial impact globally.<sup>799</sup> Massive bail-outs of financial institutions and other palliative monetary and fiscal policies were employed to prevent a possible collapse of the world's financial system. The crisis was nonetheless followed by a global [economic downturn](#), the Great Recession. The European debt crisis, a crisis in the banking system of the European countries using the euro, followed later. The Dodd–Frank Act<sup>800</sup> was enacted in the US in the aftermath of the crisis to "promote the financial stability of the United States". The Basel III capital and liquidity standards were adopted by countries around the world.<sup>801</sup>

High mortgage approval rates led to a large pool of home-buyers, which drove up housing prices. This appreciation in value led large numbers of homeowners to borrow against their homes as an apparent windfall. This bubble would be burst by a rising Single-Family Residential Mortgages Delinquency Rate (beginning in August, 2006 and peaking in the first quarter, 2010).<sup>802</sup> The high delinquency rates led to a rapid devaluation of financial instruments. Lehman Brothers filed for bankruptcy on September 15, 2008. Merrill Lynch, AIG, Freddie Mac, Fannie Mae, HBOS, Royal Bank of Scotland, Bradford & Bingley,

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"Two top economists agree 2009 worst financial crisis since great depression; risks increase if right steps are not taken". Reuters. 27 February 2009. Archived from the original on 12 February 2010. Eigner, Peter; Umlauf, Thomas S. (2015-07-01). "The Great Depression(s) of 1929–1933 and 2007–2009? Parallels, Differences and Policy Lessons". MTA-ELTE Crisis History Working Paper No. 2: Hungarian Academy of Science. SSRN 2612243. Eichengreen; O'Rourke. "A tale of two depressions: What do the new data tell us?". VoxEU.org. Temin, Peter (2010-01-01). "The Great Recession and the Great Depression". National Bureau of Economic Research.

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Williams, Mark (April 12, 2010). *Uncontrolled Risk*. McGraw-Hill Education. ISBN 978-0071638296.

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Williams, Mark (April 12, 2010). *Uncontrolled Risk*. McGraw-Hill Education. p. 213. ISBN 978-0071638296.

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"Obama-Regulatory Reform Speech June 17, 2009". *Whitehouse.gov*. June 18, 2009.

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"Monitoring adoption of Basel standards". *Bank for International Settlements*. 2 February 2016.

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"Delinquency Rate on Single-Family Residential Mortgages, Booked in Domestic Offices, All Commercial Banks [DRSFRMACBS]". *Board of Governors of the Federal Reserve System (US)*. 28 December 2016 – via FRED, Federal Reserve Bank of St. Louis.

Fortis, Hypo and Alliance & Leicester were all expected to follow – with a US federal bailout announced the following day beginning with \$85B to AIG. In spite of trillions<sup>803</sup> paid out by the US federal government, it became much more difficult to borrow money. The resulting decrease in buyers caused housing prices to plummet. While the collapse of large financial institutions was prevented by the bailout of banks by national governments, stock markets still dropped worldwide. In many areas, the housing market suffered, resulting in evictions, foreclosures, and prolonged unemployment. The crisis played a significant role in the failure of key businesses, declines in consumer wealth estimated in trillions of US dollars, and a downturn in economic activity leading to the Great Recession of 2008–2012 and contributing to the European sovereign-debt crisis.<sup>804</sup> The active phase of the crisis, which manifested as a liquidity crisis, can be dated from August 9, 2007, when BNP Paribas terminated withdrawals from three hedge funds citing "a complete evaporation of liquidity".<sup>805</sup>

The bursting of the US housing bubble, which peaked at the end of 2006,<sup>806</sup> caused the values of securities tied to US real estate pricing to plummet, damaging financial institutions globally.<sup>807</sup> The financial crisis was triggered by a complex interplay of policies that encouraged home ownership, providing easier access to loans for subprime borrowers, overvaluation of bundled subprime mortgages based on the theory that housing prices would continue to escalate, questionable trading practices on behalf of both buyers and sellers, compensation structures that prioritize short-term deal flow over long-term value creation, and a lack of adequate capital holdings from banks and insurance companies to back the financial commitments they were making.<sup>808</sup> Questions regarding bank solvency, declines in credit availability, and damaged investor confidence affected global stock markets, where

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Collins, Mike (July 14, 2015). "The Big Bank Bailout". *Forbes*.

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"Brookings-Financial Crisis" (PDF). Archived from the original (PDF) on June 2, 2010. Williams, Carol J. (May 22, 2012). "Euro crisis imperils recovering global economy, OECD warns". *Los Angeles Times*. May 23, 2012.

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Larry Elliott, economics editor of The Guardian (August 5, 2012). "Three myths that sustain the economic crisis" (blog by expert). *The Guardian*. August 6, 2012. Five years ago, the banks stopped lending to each other.

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"Median and Average Sales Prices of New Homes Sold in United States" (PDF). United States Census Bureau, United States Department of Commerce. "Quarterly Homeownership Rates and Seasonally Adjusted Homeownership Rates for the United States: 1997–2014" (PDF). *US Census*. May 5, 2006.

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This American Life (April 2009). "The Giant Pool of Money". Pri.org. Archived from the original on April 15, 2010. Michael Simkovic, *Competition and Crisis in Mortgage Securitization*.

securities suffered large losses during 2008 and early 2009. Economies worldwide slowed during this period, as credit tightened and international trade declined.<sup>809</sup> Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion and institutional bailouts.<sup>810</sup> In the US, Congress passed the American Recovery and Reinvestment Act of 2009. In the United States President Barack Obama and key advisers introduced a series of regulatory proposals in June 2009. The proposals address consumer protection, executive pay, bank financial cushions or capital requirements, expanded regulation of the shadow banking system and derivatives, and enhanced authority for the Federal Reserve to safely wind-down systemically important institutions, among others.<sup>811</sup> In January 2010, Obama proposed additional regulations limiting the ability of banks to engage in proprietary trading. The proposals were dubbed "The Volcker Rule", in recognition of Paul Volcker, who has publicly argued for the proposed changes.<sup>812</sup>

The US Senate passed a reform bill in May 2010, following the House, which passed a bill in December 2009. The New York Times provided a comparative summary of the features of the two bills, which address to varying extent the principles enumerated by the Obama administration.<sup>813</sup> The Volcker Rule against proprietary trading is not part of the legislation, though in the Senate bill regulators have the discretion but not the obligation to prohibit these trades. European regulators introduced Basel III regulations for banks.<sup>814</sup> It increased capital ratios, limits on leverage, narrow definition of capital, limit counter-party risk, and new liquidity requirements.<sup>815</sup> Critics argue that Basel III does not address the problem of faulty risk-weightings. Major banks suffered losses from AAA-rated created by financial

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Keller, Christopher; Stocker, Michael. "Executive Compensation's Role in the Financial Crisis". *The National Law Journal*. Retrieved January 7, 2014. Michael Simkovic, "Secret Liens and the Financial Crisis of 2008" *American Bankruptcy Law Journal*, Vol. 83, p. 253, 2009. "Money, Power and Wall Street, Part 1". *PBS. Ivry, Bob (September 24, 2008)*. "quoting Joshua Rosner as stating 'It's not a liquidity problem, it's a valuation problem.'". *Bloomberg*.

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"World Economic Outlook: Crisis and Recovery, April 2009" (PDF).

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"Kavaljit Singh, Fixing Global Finance: A Developing Country Perspective on Global Financial Reforms, Stichting Onderzoek

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"Remarks of the President on Regulatory Reform | The White House". *Whitehouse.gov*. June 17, 2009. Retrieved November 11, 2009. *View all comments that have been posted about this article. (June 14, 2009)*. "Geithner & Summers – A New Financial Foundation". *Washington Post*. Retrieved May 1, 2010. "Treasury Department Report – Financial Regulatory Reform". *Financialstability.gov*. March

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Uchitelle, Louis (January 22, 2010). "Glass-Steagall vs. the Volcker Rule". *The New York Times*. Retrieved January 27, 2010.

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New, The (May 20, 2010). "New York Times-Major Parts of the Financial Regulation Overhaul-May 2010". *The New York Times*.

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"Group of Governors and Heads of Supervision announces higher global minimum capital standards" (PDF). September 12, 2010.

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engineering that required less capital according to Basel II. Lending to AA-rated sovereigns has a risk-weight of zero, thus increasing lending to governments and leading to the next crisis.<sup>816</sup> Johan Norberg argues that regulations (Basel III among others) have indeed led to excessive lending to risky governments and the ECB pursues even more lending as the solution.<sup>817</sup> When the bubble bursts, reactions are fairly imminent, and they take the shape of legislations enacted to correct what are the perceived malfunctions. That was the case with the Bubble Act 1720<sup>818</sup> as a response to the South Sea Bubble, as well as a decade ago with the very prompt launch of the Sarbanes-Oxley Act in 2002.<sup>819</sup> The global meltdown has been followed by similarly prompt reactions in the UK, in the US and at EU level most prominently. These interventions did not necessarily reflect the full gravity of the crisis and most importantly the depth of regulatory flaws that became apparent in its aftermath. Despite the global crisis having been rightly compared to the 1929 Great Crash, the 2008 panic has not been followed by the same drastic regulatory corrections implemented eighty years earlier.<sup>820</sup>

While a more radical revision of the financial system has been advocated within some circles<sup>821</sup>, reforms so far have somewhat remained timid attempts to cure a chronic disease without eradicating its very source. There is a clear willingness to cling to a business model that the crisis unveiled as fundamentally flawed.<sup>822</sup> Not only the global meltdown, but as

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Elliott, Douglas J. (July 26, 2010). *"Basel III, the Banks, and the Economy"*. Brookings Institution.

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*"Third time's the charm?"*. The Economist. September 13, 2010.

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Norberg, Johan (May 2012). *"Financial Crisis II: European governments fail to learn from history"*.

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*Royal Exchange and London Assurance Corporation Act 1719, which restricted the application of limited liability to all but few entities.*

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*Pub. L. 107-204, 116 Stat. 745, 2002.*

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These flowed into the establishment of the SEC, probably the first financial regulator in history, and into the enactment of a number of legislative measures, among which the Glass Steagall Act.

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A. Turner "Reforming Finance: Are We Being Radical Enough?", 2011 Clare Distinguished Lecture In Economics and Public Policy, FSA, 18 February 2011, p.25.

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evidenced in these case studies, a whole decade of corporate and financial failures, all pointed at similar corporate governance malfunctions and at the dangers and abuses of overdeveloped capital markets.<sup>823</sup> It is worth stressing on this point that while developed capital markets are instrumental to the life of industrial enterprises, the age of financialisation in Anglo-American economies has brought about a model that clearly departed from the social role of financial markets. This resulted in a huge apparatus that exists to serve its own purposes of extracting value from society, rather than creating value for it.<sup>824</sup> The growth of the global financial system along these lines led to critical shifts in many countries that forsook traditional industrial economies to embrace financial ones based on inflated financial services sectors.<sup>825</sup> The legal mechanisms underpinning this new model are scrutinised for their dubious rationale. Innovative products like CDOs and CDSs have come to light as being largely speculative tools that did not encompass any economic or social function, but rather contributed to the emergence of a hidden universe of risks, losses and liabilities. Countering the axioms of prevailing neoliberal ideologies, it was suggested that the end-stage of large financial markets was represented by a high level of leverage whereby the debt burden keeps increasing and firms continue borrowing to pay interests.<sup>826</sup> This theorised scenario is close to representing what triggered the credit crunch in 2007. The same neoliberal propositions that are embraced as conventional wisdom in most financial circles, led in the years before the crisis to theorise through quantitative models that certain events could only happen once in a thousand years. In August 2007 those events happened for three days in a row.<sup>827</sup>

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P. Jenkins "FSA's head targets "shadow banking", *Financial Times*, April 18, 2012. In response to Adair Turner's proposals, one investment bank chief said "I believe in a market economy, Turner doesn't I guess. This is all about a centrally planned economy, this is anti-competitive".

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These are epitomised by the label of "steroid banking" used in "Wall Street, Money Never Sleeps", directed by O. Stone, 2010, "They got all these fancy names for trillions of dollars of credit, CMO, CDO, SIV, ABS; you know I honestly think there's maybe only seventy-five people around the world who know what they are..."; "We take a buck, we shoot it full of steroids, we call it leverage. I call it steroid banking".

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Gallino 2011, ch.1.

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Ibid. These two types of capitalism differ for the way in which capital is created. Industrial capitalism applies the traditional paradigm whereby initial capital is invested into production and from the sale of produced goods a profit is made, which is the resulting capital.

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H.P. Minsky and M.H. Wolfson "Minsky's Theory of Financial Crisis in a Global Context", *Journal of Economic Issues*, June 1, 2002; H.P. Minsky "The Financial Instability Hypothesis", in *Handbook of Radical Political Economy*, by P. Arestis and M. Sawyer, Edward Elgar, 1993.

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K. Whitehouse "Quant expert sees a shakeout for the ages", *Wall Street Journal*, 14 August 2007.



The considerations are a statement to the need to reconsider the role that financial systems play in society. This is the lesson to draw from the global meltdown and it is worth reiterating the view that reforms have not fully reflected it as they are rather directed at trying to perpetuate a system by correcting some of its manifestations, whereas its foundations are hampered by a flawed ideology. The global financial system resulting from the age of financialisation is characterised by a sheer lack of democratic process underpinning its governance.<sup>828</sup> Problems of legitimacy and accountability have progressively been exacerbated by an industry that was internalising its gains while externalising its losses, thanks to connections that from the 1980s onwards have linked financial circles to political ones, resulting in the deregulation process in the undisputed application of neoliberal free-market principles.<sup>829</sup> The ensuing free-market anarchy that permeated large sections of the financial services industry could fit into an “Hobbesian” scenario, where the lack of legitimate governance may lead according to the English philosopher to a condition where individuals would have a right to do anything, that being well synthesised in the Latin maxims “homo homini lupus” and “bellum omnium contra omnes”.<sup>830</sup> These are arguably the stages that regulators should prevent from occurring.

While the Dodd-Frank did tackle some pressing issues, namely the urgency to regulate speculative derivatives, the public agency established in the Act is not empowered to face the lobbying power of Wall Street investment banks. Some of the propositions underlying EU initiatives present a more negative approach towards regulating the market. CRD IV<sup>831</sup> for instance reflected a sense of resignation that regulation cannot prevent disintermediation of capital flows, and that the shadow banking system is not well enough defined to apply onerous regulation upon firms.<sup>832</sup> If on paper ESMA represents a more fundamental change in the centralisation of cross-border financial markets’ supervision, some of its powers are constrained by formal triggers and its institutional status risks to diminish its activity to that of a collective actor.<sup>833</sup>

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Supra Gallino 2011, ch.1. See D. Muegge “Limits of Legitimacy and the Primacy of Politics in Financial Governance”, *Review of International Political Economy*, Vo.18, Issue 1, 2011, where it is argued that legitimacy deficits persist in the capital markets policy-making due to excessive influence of the financial industry, compared to other stakeholders.

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Supra Gallino 2011, p.23,24. This refers to the exchange of high-rank personnel from financial institutions to political public ones, which has favoured the deregulation process.

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T. Hobbes “Leviathan – Of the Natural Condition of Mankind as Concerning Their Felicity and Misery”, 1651, ch.13.

831

European Commission, Proposal for a Directive of the European Parliament and of the Council amending Directive 2002/87/EC, COM(2011) 453 final.

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J. Berg “CRD IV: The new EU framework for capital and liquidity requirements”, EPFSF Lunch Discussion, 4 may 2011.

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In order to examine more about crises and regulation, we are now moving onto the next chapter as it is considered that topic is one of an important topics in this thesis, besides, we may know more clearly about the reforms and the Basel Committee on banking supervision. Besides, we go to chapter four to look into the relative importance of internal corporate governance controls and external corporate governance controls.

### **The Banking (Special Provisions) Act 2008**

The Banking (Special Provisions) Act 2008 was the piece of legislation passed in the UK as a response to the financial crisis. It was designed to assist in the rescue of Northern Rock. The long title of the act states its purpose as an act to make provision to enable the Treasury to make an order relating to the transfer of securities issued by, or of property, rights or liabilities belonging to, an authorised deposit-taker; to make provision in relation to building societies; and for connected purposes. It received Royal Assent on 21 February 2008 and under this act, Order SI2008/432 was made.

The powers granted under the Act were used for the nationalisation of Northern Rock, the Act was drafted generically. It allowed for the creation of statutory instruments to enable the rescue of Northern Rock and future bank failures. Alistair Darling, the Chancellor of the Exchequer made the comment at the reading that the Government have no intention at present to use the Act to bring any institution other than Northern Rock into public ownership. This reflected politicians' opinion, it was to be overtaken by the events that followed. The powers granted under this Act have been used for government interventions in the banking sector, which, given the crisis that was going on, must have been foreseen with some degree of certainty. The powers were used to nationalise the mortgage and loan books of Bradford and Bingley, which was part-nationalised and part transferred to Abbey National under SI2008/2546 on the 29th September 2009. They were used to transfer deposits from Heritable Bank, part of the Icelandic Landsbanki, and from Kaupthing Edge to ING Direct, part of the Dutch financial conglomerate ING Group, under a range of statutory instruments SI2008/2644, SI2008/2646 and SI2008/2674 on the 7th and 8th of October 2009. The Act became a tool for the UK government to handle bank failures. Sections 3 and 6 of the Act describe the powers granted to the Treasury.

Northern Rock was transferred to a nominee of the Treasury, in this case UKFI. In support of the powers granted under section 3, the Treasury is allowed under section 4(2) to extinguish the subscription rights associated with the securities. Section 3(1) is the core of the rescue operation. In establishing this mechanism, it is recognised that allowing an authorised UK deposit-taker, such as a bank or building society, to fail has the potential to create a detriment to the economy and society. In establishing section 3(1), one could say that the importance of the public as an external stakeholder is recognised in statute.

The exercise of the powers granted by the Act is subject to the constitutional checks and balances. The check on the power given is that the Treasury Ministers and the Chancellor, whilst acting on advice of the FCA and the Bank of England as per the Memorandum of

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P. Schammo "The European Securities and Market Authority: Lifting the Veil on the Allocation of Powers", Common Market Law Review 48 1879, 2011.

Understanding, are accountable to Parliament.<sup>834</sup> Parliament as well as the parliamentary committees can scrutinise decisions to exercise the powers. The Icelandic bank Kaupthing Bank HF applied for judicial review of the Treasury's decision to make the order to transfer deposits held by its subsidiary.<sup>835</sup> The Treasury had used the powers under section 6 of the Act to make this order after the then FSA had judged the subsidiary to be in serious financial difficulty. The order was made because of the threat to the stability of the UK financial system as per the purpose set out in section 2(2)(a). The two grounds of the challenge were that the purpose of the Treasury was not to maintain the financial stability but to protect the depositors and that HM Treasury had failed to identify the threat to financial stability in the UK posed by the financial difficulties of the subsidiary. The application was refused. It was held that the objective was the financial stability, whilst the second ground was deemed artificial and unreal. It is the first ground which is most interesting as it demonstrates the difficulties under which the Treasury has to operate.<sup>836</sup> HM Treasury needs to formulate its reasons for exercising its powers in precise terms for when it is scrutinised by courts and lawyers.

In another example of a challenge by way of judicial review, the applicants, former shareholders of Northern Rock, argued that the compensation payable to them following nationalisation was unfair and incompatible with their rights under the ECHR Protocol 1 Article 1.<sup>837838</sup> It was held that the assumptions that the independent valuer had to make for the Northern Rock shares were not contrary to the shareholders' right of possession pursuant to the Human Rights Act 1998. The claims by SRM for a judicial review were dismissed. The court held that 3 principles, as established by the case-law of the European Court of Human Rights, were all in place: the need for a fair balance to be struck between public interests and private rights, the principle of proportionality and the doctrine of the margin of appreciation. The compensation scheme required putting shareholders in the same situation as if the intervention had not taken place. The regulators did not owe a duty to shareholders. On appeal to the European Court of Human Rights, the Court found that the applicants' complaint under Article 1 of Protocol 1 was manifestly ill-founded and inadmissible.<sup>839</sup> The

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HC 19 February 2008, vol 472, col 254

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R. (on the application of Kaupthing Bank HF) v HM Treasury [2009] EWHC 2542 (Admin)

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Joanna Gray, 'Case Comment: High Court considers Icelandic bank's challenge to HM Treasury's use of emergency powers during 2008' (2010) JFR&C 18(2) 178

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R. (on the application of SRM Global Master Fund LP) v Treasury Commissioner [2009] EWCA Civ

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, on appeal from R. (on the application of SRM Global Master Fund LP) v Treasury Commissioner [2009] EWHC 227 (Admin)

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Grainger v United Kingdom (2012) 55 EHHR SE13

compensation arrangements for the transfer of securities under section 3 are set out under section 5. Compensation is to be decided by an independent valuer. The Chancellor, Mr Alistair Darling, said of the compensation, that the valuer must assume that financial support provided by the Bank of England and the Treasury has been withdrawn and that no further public financial support will be given, apart from the ordinary market support provided by the Bank of England.<sup>840</sup> The argument for this principle is that the bank would go bankrupt without government support.

There have been various challenges brought in respect of the compensation measures. An application to this extent was brought in relation to Bradford & Bingley before the Upper Tribunal (Tax and Chancery). It was refused on the grounds that the tribunal did not have the authority to question the manner in which the valuer was appointed nor the rules governing his approach to the valuation of the compensation.<sup>841</sup> An earlier case before the same tribunal was heard, concerning the valuation of Northern Rock on nationalisation and the reading of has been withdrawn in section 5(4).<sup>842</sup> The point the claimants made was that financial support never was withdrawn or it was withdrawn over a longer period and in any event not as intended under section 5(4). The result would have been that share prices and compensation would have been higher. This argument was rejected by the court, a decision upheld by a majority in the Court of Appeal.<sup>843</sup>

## The Banking Act 2009

The Banking Act 2009 replaced the Banking (Special Provisions) Act 2008. This was necessary as the 2008 Act contained a provision that limited the power to the Treasury to only one year after passing of the Act. It was not introduced with the same urgency as the previous Banking Act and went through the consultation process. This new Banking Act is much larger and more complex than Banking Act 2008. The objective of the act is to establish a framework for handling the insolvency of a bank in the UK through the use of a Special Resolution Regime. The passing of the Act was accompanied by two statutory instruments coming into force. The first is the Banking Act 2009 (Restriction of Partial Transfers) Order This statutory instrument gives a bank protection from interference when it is placed in the Special Resolution Regime. The other is the Banking Act 2009 (Third Parties Compensation) Regulations, which makes provisions for compensation of third parties left behind in a failing bank. The Bank Insolvency part provides for the windup of a

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<sup>841</sup> HC 19 February 2008, vol 472, col 178

Bradford & Bingley Applicants v Clokey (UKUT (TCC), 19 July 2012)

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Northern Rock Applicants v Caldwell [2011] UKUT 408 (TCC)

<sup>843</sup>

Harbinger Capital Partners v Caldwell [2013] EWCA Civ 492

failing bank and facilitates rapid payments from the Financial Services Compensation Scheme (“FSCS”) or a transfer of relevant accounts to another financial institution.

As with the Banking (Special Provisions) Act 2009, the new Banking Act 2009 can be said to recognise the importance of the public at large as an external stakeholder, see also Financial Services and Market Act 2000. As with its predecessor, the new Act contains provisions to arrange what is effectively a rescue or an orderly wind-down of an authorised deposit holder. The beneficiary of this is the general public.

## The Special Resolution Regime – Current State

### The Objectives and the Code of Practice

The Banking Act 2009 ss5,6 require HM Treasury to set out a Code of Practice. This Code of Practice must contain the guidelines the authorities will use the powers under the Special Resolution Regime<sup>844</sup> and is updated to include changes to the Banking Act 2009 and related legislation.<sup>845</sup> The Code of Practice covers the 3 stabilisation options, the bank insolvency procedure and the bank administration procedure. The authorities are obliged to have regard for the Code under section 5(4). Some of its main points include how the special resolution regime’s objectives are to be understood and achieved, the choice between different resolution options, compensation, and how the Bank of England will determine the public interest test for the use of the bridge bank and private purchaser stabilisation options is satisfied.

The Code provides the interpretation and explanation. The stability of the financial systems of the UK is defined to include capital raising, risk-transfer, facilitation of domestic and international commerce, and the continuity of the banking system and systemic impact. A broad definition is given for public confidence in the stability of the banking system. It includes the expectation that deposits will be repaid, that banking services will continue to be available, that problems in one institution will not extend to another, and that if an institution fails, a system exists to protect the interests of depositors. All other objectives of the regime are defined.

### The Main Powers

The Special Resolution Regime, the first part of the Act, is the UK’s statutory toolkit for resolving failing banks and building societies. At the time when the Act came into force, the three authorities, namely the then FSA, the Bank of England and the Treasury, could exercise the powers granted. First, the FSA determined whether a bank had met the conditions to be placed under the Special Resolution Regime. Either the Bank of England

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HM Treasury, ‘Banking Act 2009 Special Resolution Regime: Code of Practice’ (November 2010) <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/209933/banking\\_act2009\\_code\\_of\\_practice.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209933/banking_act2009_code_of_practice.pdf)>

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HM Treasury, ‘Banking Act 2009 Special Resolution Regime: Code of Practice’ (March 2015) <[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/411563/banking\\_act\\_2009\\_code\\_of\\_practice\\_web.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/411563/banking_act_2009_code_of_practice_web.pdf)>

would take over implementing and running the Special Resolution Regime. Only in the case of transfer to temporary public ownership would the Special Resolution Regime be run by the Treasury.

The situation is different as, following the Financial Services Act 2012, the FSA was replaced as the financial services regulator. In its place came the Prudential Regulation Authority (“PRA”) and the Financial Conduct Authority (“FCA”). The provisions have become complicated. There are 4 conditions under section 7 that need to be satisfied before a bank is to be placed in the Special Resolution Regime. The first condition is that the PRA needs to be satisfied that the bank is failing or is likely to fail. The Bank of England needs to be satisfied of three conditions. The first is that, it is not likely action will be taken by or in respect of the bank that will result in the PRA’s condition ceasing to be met. The second condition is that the exercise of the power is necessary having regard to the public interest in the advancement of one or more of the special resolution objectives. The third condition is that one or more of the special resolution objectives would not be met to the same extent by the winding up of the bank. There are provisions under section 7 which apply to these conditions. Although one of the regulators must determine whether a condition is met, the others are to be consulted. The Special Resolution Objectives are relevant to the Bank of England’s second and third conditions. It is worth noting that provisions are included on the relation between failure and financial support. When the Banking Act 2009 came into force, there were three options available for resolving a failing institution. The Bank of England had the power to sell all or part of a failing bank to a commercial purchaser. This was the private sector purchase option and could be executed by share or property transfer instruments. In the second option, the Bank of England can transfer all or part of the failing bank to a bridge bank. The third option is a transfer by the Treasury of the institution into public ownership. This has changed since January 1, 2015, when the Bank Recovery and Resolution Order 2014/3329 came into force. This was one of several Statutory Instruments that form the transposition of the Bank Recovery and Resolution Directive<sup>846</sup> (“BRRD”) into UK law.

## **Depositor Protection**

The Financial Services Compensation Scheme (“FSCS”) was introduced through the Banking Act 2009 Part 4, sections 169 to 180. This is a part of the Act for retail customers as it changes the insolvency hierarchy and gives preference to depositors. FSCS covered deposits rank with other preferential debts, whilst those not covered are preferred over unsecured debt but rank below other preferential debts. This reduces the likelihood that the FSCS will need to contribute to the resolution. Worth noting is the case of a bail-in, where the FSCS is required to contribute up to the amount it would have had to pay out in the alternative of an insolvency. In case of an insolvency, the bank liquidator is required to work

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Council Directive 2014/59/EU of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012 [2014] OJ L173/190, available at <<http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN>>

together with the FSCS to facilitate prompt pay outs to eligible depositors or to facilitate the transfer of deposits as a whole to another institution. This is important considering the procedures involved in the liquidation of a bank. It would be unrealistic to expect customers to wait for months if not years to get their deposits back.

### **Critical Analysis of the Banking Acts**

The Banking (Special Provisions) Act 2008 and the nationalisation of Northern Rock are praised as perhaps the measures taken by any country to deal with a bank failure during the crisis. Even if this is exaggerated, it must be accepted that the handling of Northern Rock provided a blueprint for handling the smaller failures and, for the much larger failures of RBS and Lloyds HBOS. The lesson is that the focus of policymakers should not be on trying to prevent a crisis, but also on managing a crisis when one arrives. If risktakers are protected from the negative outcomes of the risks undertaken, they may in future engage in greater risk.<sup>847</sup> There is pressure on policy makers to take action, as inaction will lead to disastrous outcomes.

The Banking Acts are necessary steps towards such a resolution system in the UK. It may be adequate for smaller national institutions, the financial institutions that are deemed to be important have adopted a complex corporate structure. This makes the application of such Acts difficult in practice; the suggestion is made that important financial institutions should be required to write and update a winding-down plan together with their business continuity plans. If this winding-down plan is deemed to be inadequate, supervisors should be given the power to force through changes in the corporate structure of the important institution. The requirement to draft these plans has made its way into law via the BRRD, and the plans form the basis of conversations between the regulator and the banks, it remains an untested tool for important institutions. The Banking Act 2009 and the BRRD reflect this in the objectives set to the liquidator in the Special Resolution Objectives discussed: the priority goes to safeguarding deposits. Third Parties Compensation Regulation, which makes provisions for third parties left behind in case of a failure, as well as the FSCS designed to protect deposit holders. The predecessor of the 2009 Act, namely the Banking (Special Resolutions) Act 2008, has been demonstrated that the safeguarding of wider public interests and of depositors does not please all parties involved. It is difficult to balance the right of shareholders with such a form of regulation,<sup>848</sup> see also Henry VIII clauses, Theresa May is taking a lead from a frequently divorced former monarch in preparing the way for life after the Brexit break-up. In order to deal with tens of thousands of EU laws, regulations, treaties and directives that must be incorporated into UK law on Brexit Day, the British government wants to invoke controversial powers that date back 500 years to the time of King Henry VIII. The so-called "Henry VIII clauses" in the will give ministers and civil servants

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Richard J Herring, 'The Known, the Unknown and the Unknowable in Financial Policy: An Application to the Subprime Crisis' (2009) 26 Yale J on Reg 391, 401

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Kern Alexander, 'Bank Resolution Regimes: Balancing Prudential Regulation and Shareholder Rights' (2009) 9 J Corp L Stud 61

sweeping authority to comb through the vast EU legislative soup and decide which bits to keep, which to amend, and which to repeal in their entirety. Crucially, ministers can wave the decisions through without recourse to the House of Commons.<sup>849</sup>

## Other Jurisdictions

In the US, the Dodd-Frank Wall Street Reform and Consumer Protection Act 2009, or the Dodd-Frank Act, was the comprehensive piece of legislation to be passed as a response to the financial crisis. It covers the supervision of financial institutions; a new resolution procedure for large financial companies; more stringent rules on banking capital; the creation of a new agency for enforcing consumer financial laws; the Volcker rule and regulation of over-the-counter derivatives.

The EU has implemented a range of regulations and directives in response to the crisis.<sup>850</sup> The BRRD for recovery and resolution and the FSCS have been discussed. The Credit Requirement Directive IV<sup>851</sup> (“CRD IV”), which goes together with the Credit Requirements Regulation<sup>852</sup> (“CRR”), are the implementation into EU legislation of Basel III. These include the requirements in relation to the capital that institutions are required to hold. Where the CRR is applicable, CRD IV has been transposed by the PRA and the FCA into their handbooks for their firms. For the Eurozone countries, the responsibility lies with the European Central Bank (“ECB”). The European Supervisory Bodies, such as the European Banking Authority (“EBA”), are tasked with drafting delegated legislation. This involves drafting the technical standards to support some of the articles. CRD IV and the CRR came into force on 1 January, 2014, although full compliance with Basel III is not a requirement until 1 January, 2019. The difference between CRD IV and the CRR is that the CRR focusses on the requirements for capital, liquidity and leverage.

Apart from differences and specifications of the capital requirements, the difference between CRD IV and Basel III is that CRD IV sets restrictions on the remuneration. There will be a ratio of fixed and variable pay of one on one. Subject to shareholder approval, this can be increased to one on two. Those within scope would include senior management, risk takers, staff engaged in control functions or anyone else whose remuneration is of such a level that

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Brexit: Great Repeal Bill invokes 'Henry VIII clauses' - CNN - CNN.com 30-3-2017  
<https://www.cnn.com/2017/03/30/europe/...henry...clauses/index.html>

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Paulina Dejmek, 'The EU Internal Market for Financial Services – a Look at the First Regulatory Responses to the Financial Crisis and a View to the Future' (2009) 15 Colum J Eur L 456

851

Council Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC OJ L 176/338, available at <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0338:0436:EN:PDF>>

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Council Regulation (EU) No 575/2013 of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 OJ L176/1 available at <<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:176:0001:0337:EN:PDF>>



they should be in those categories. There are some technical requirements around it, it is fair to say that anyone who has worked in an investment bank in London for over five years is likely to be caught under this definition.

## **Conclusion**

This chapter discusses the UK and US regulatory response which took place in the UK and in US. Despite a lack of large-scale corporate collapses in the UK, proposed UK reforms have been strongly influenced by the corporate scandals in the US. The Sarbanes-Oxley has been called the most sweeping corporate regulation measure in decades. Congress intended to assure that auditors would point out financial shenanigans by their corporate clients before fraud or conflicts of interest can hurt a company, its employees and its investors. A brief examination of executive pay and corporate integrity and corporate governance reforms give us a more complete picture of the corporate governance reforms. Starks said that during the 1990s, it seemed as though CEOs were being generously rewarded for having the good fortune of riding the economic boom. Sherron Watkins, the Enron whistleblower said compensation plans such as Grasso's are unnecessary as well as excessive. In discussing with Dodd-Frank Wall Street Reform and Consumer Protection Act, after the 2007 global financial crisis, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was signed into federal law by president Barack Obama on July 21, 2010 in Washington, DC. Passed as a response to the 2000s recession, it brought the most significant changes to financial regulation in the United States since the regulatory reform that followed the great depression. Finally, the Banking Acts are necessary steps towards such a resolution system in the UK. It may be adequate for smaller national institutions, the financial institutions that are deemed to be important have adopted a complex corporate structure.

To conclude, it appears that Sarbanes-Oxley in the US does not appear to be able to deter corporate governance flaws in banking and in addition, the CA 2006 and the corporate governance codes appear not to work too much in the UK and this is why updated corporate governance were launched in the UK and this is also why Dodd-Frank came about after it. The insights of this chapter stated why the regulatory response, key implications of the regulatory responses especially linking to pertinent corporate governance issues is that the regulators have to work out an infrastructure that promotes good corporate governance. This leads to the question of the general effectiveness of these financial regulations in addressing financial crisis, and this appears be the focus of chapter 4, the next chapter.

## **Chapter 4**

### **Introduction**

Monitoring by the board of directors: with its legal authority to hire, fire and compensate top management, safeguards invested capital. Regular board meetings allow potential problems to be identified, discussed and avoided. Whilst non-executive directors are thought to be more independent, they may not always result in more effective corporate governance and may not increase performance. Different board structures are optimal for different firms. Besides, U.S. Securities and Exchange Commission and the Basel Committee is also important and is examined in this chapter.

### **Crises and Regulation**

#### **The relative importance of internal and external corporate governance controls**

Internal control procedures and internal auditors: internal control procedures are policies implemented by an entity's board of directors, audit committee, management, and other personnel to provide reasonable assurance of the entity achieving its objectives related to reliable financial reporting, operating efficiency, and compliance with laws and regulations. Internal auditors are personnel within an organization who test the design and implementation of the entity's internal control procedures and the reliability of its financial reporting. Performance-based remuneration is designed to relate some proportion of salary to individual performance. In the United States, the problem is the conflict of interest between widely-dispersed shareholders and powerful managers. In Europe, the problem is that the voting ownership is tightly-held by families through pyramidal ownership and dual shares. This can lead to self-dealing, where the controlling families favor subsidiaries for which they have higher cash flow rights.<sup>853</sup> These tend to be small companies, with some

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exceptions. The legal implications for the corporate governance in this thesis are to focus on US and UK banking sector. Despite there are some difference between the US and UK institutions failure, their failure are due to the similar reasons namely poor management, inadequate regulations and no regulators who can execute the regulations in a proper way. We need to look into global financial regulations and norms explaining particular on how they could help the strengthening of corporate governance practices. History has shown that regulation emerges after periods of crisis. Such regulation has rarely come about as a consequence of rational deliberation, but it takes the form of panic stricken short-term responses to the crisis that has passed.<sup>854</sup> A series of new laws and rules is being introduced aiming at restoring the public's confidence and preventing a similar crisis from happening again.

Financial markets are unpredictable and prone to extremes, but this does not mean that there is no time for a more thoughtful and comprehensive approach in order to address the financial issues and problems. There is an inherent instability in our sort of economy and argued that the processes that generate financial fragility are natural or endogenous to the system.<sup>855</sup> He was one of the first to discuss financial instability more than 50 years ago and he argued that crises are part of the economy's evolutionary process: when crises are successfully contained, then risky practices are validated and this sets the stage for subsequent crises. The periods between two crises, the tranquillity periods,<sup>856</sup> are the most crucial, because they encourage not only more innovative behaviour, but more risk-taking as well.<sup>857</sup> Tranquillity is disrupted by excessive risk-taking and market instability, the economy moves away from equilibrium and an atmosphere of uncertainty is created in the markets. Disclosure systems that are founded on high-quality standards give investors confidence in the credibility of financial reporting - and without investor confidence, markets cannot thrive.<sup>858</sup> There are so many people that are affected and so many vulnerable parties

<http://www.answers.com/topic/corporate-governance>

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Andenas, M., Who is going to supervise Europe's Financial Markets' in Andenas, M. and Avgerinos, Y. (eds), *Financial Markets in Europe: Towards a Single Regulator?*, Kluwer Law International, The Hague, 2003, xvi.

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Papadimitriou, D.P. and Wray, L.R., *Minsky's Stabilizing an Unstable Economy: Two Decades Later* in Minsky, H.P., *Stabilizing an Unstable Economy*, Yale University Press, USA, 2008.

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Ibid.

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Ibid. High Level Group on Financial Supervision in the EU, Report, Brussels, February, 25, 2009, available in the website: [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf) , at point 112: In such an environment, investors and shareholders became accustomed to higher and higher revenues and returns on equity which hugely outpaced for many years real economic growth rates. Few managers avoided the herd instinct – leading them to join the competitive race even if they might have suspected that risk premia were falling and that securitisation as it was applied could not shield the financial system against bad risks.

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Kothari, S. P., The Role of Financial Reporting in Reducing Financial Risks in the Market, in *Building and Infrastructure for Financial Stability* , in Rosengren, E.S., and Jordan, J.S., (eds), *Building an Infrastructure for Financial Stability*, Federal Reserve Bank of

involved that total absence of regulation is inconceivable. A well-designed legal framework with clear and effective rules is essential to replace fraudulent practices and insecurity and contribute to the harmonious operation of the financial markets. President Lincoln once wrote that the legitimate object of a government is to do for a community of people, whatever they need to have done, but cannot do at all or cannot so well do for themselves - in their separate and individual capacities.<sup>859</sup>

In relation to corporate governance in Europe, there has been a trend towards the application of reflexive modes of governance in the EU. Reflexive harmonization can be seen as the latest in a series of developments, which have seen the emergence of more reflexive modes. It will be treated as an informal mechanism, complementary to the formal legal mechanisms associated with lawmaking via directives and Court judgements.<sup>860</sup> Regulation can reinforce the foundations of the system and support any attempt for economic growth. Compliance and enforcement play a central role for the overall assessment of a regulatory initiative. An example supporting the argument is the Satyam Computer Services fiasco. On the 7<sup>th</sup> of January 2009, Ramalinga Raju, the Chairman of the Board of Directors of the company, resigned after admitting that Satyam's accounts had been falsified. It was the second time within a year that the company's name was in the headlines of the business newspapers within the same year. The paradox is that the first time was when Satyam Computer Services was the winner of the Golden Peacock global award for 2008. Penalties and fines can have an intimidating effect, but they do not solve the problem in the long run. If an event with widespread and severe economic and social consequences keeps on repeating itself, the onus is surely on the authorities to change something.<sup>861</sup> It is time for corporate governance to move forward, away from traditional regulatory solutions, because none of them so far seem to be successful in preventing similar crises from happening again. The focus of any post-crisis reform should be dual to reverse the negative effect, dealing with the existing implications of a crisis/scandal, by supporting the market, strengthening the legal framework and restoring the public trust and confidence; and to prevent similar events in the future, by identifying the gaps in the current regime, assessing the potential threats and protecting vulnerable groups. Past experience can be used as a guide for the future, but not

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Boston Conference Series, No. 44, June 2000, pg. 91.

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Fehrenbacher, Don E., (ed.), *Speeches and Writings, 1832-1858: Speeches, Letters, and Miscellaneous Writings*, the Lincoln-

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Sabel, C. and Zeitlin, J., *Learning from Difference: The New Architecture of Experimentalist Governance in the European Union*, (2006), paper presented to the Theory of the Norm Workshop, FP6 project Reflexive Governance in the Public Interest, Brussels, 27 October 2006. See Deakin, S., *Reflexive Governance and European Company Law*, (2009), *European Law Journal*, Vol. 15, Issue 2, 224-245 at 244-5.

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Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A.D. and Shin, H., *The Fundamental Principles of Financial Regulation*, (2009), Geneva Reports on the World Economy No 11, International Centre for Monetary and Banking Studies and Centre for Economic Policy Research, foreword.

exclusively, because if regulation is only targeted at specific types of failures, it runs the danger of becoming myopic.<sup>862</sup>

In the USA, the SoX introduced stricter liability accompanied with severe penalties and fines in an attempt to build a protective wall against fraud. There were statements suggesting that the SoX may be increasing accountability and reducing risk-taking in a way that could be construed as positive<sup>863</sup> and that it has the capacity to reward truthful corporations and their management.<sup>864</sup> The reform failed to make legislation proactive and align the remuneration with the sustainability of a company's performance. The establishment of an ethics culture' was not encouraged, although a few years earlier unethical business conduct evidently led several companies to the brink of bankruptcy or collapse. It could be argued that in Rule 33-8177<sup>865</sup> the SEC defined the term code of ethics' and introduced written standards designed to deter wrongdoing and to promote ethical handling of conflicts of interest, disclosure, compliance with applicable laws, prompt internal reporting of violations, and accountability for adherence to the code. There is not yet any solid empirical evidence to suggest that the requisite societal environment for an ethical corporate culture, including appropriate situational constraints on behaviour, has developed or is developing in such a way as to support SoX's ethical mission or that the SoX encourages the kind of behaviour and transparency that is exhibited by ethical role models.<sup>866</sup> Even the certification requirements in sections 302 and 906 do not really contribute to the reinforcement of ethical behaviour, because senior executives are overwhelmed by compliance-related activities for fear of criminal liability and strict penalties, affording them little time to engage in the kind of open, transparent interactions with each other and others in the corporation that will enable the establishment, transmission, and internalization of ethical values in the company.<sup>867</sup>

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Kay, J., More Regulation Will Not Prevent Next Crisis, Financial times, 26 March 2008, available in the website:

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Langevoort, D.C., The Social Construction of Sarbanes-Oxley, (2007), 105 Mich. L. Rev. 1817 at 1828–33.

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Frankel, T., Using the Sarbanes-Oxley Act to Reward Honest Corporations, (2006), 62 Bus. Law 161 at 161

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SEC Final Rule #33-8177, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, issued on January 23, 2003, available in the website: <http://www.sec.gov/rules/final/33-8177.htm>.

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MacLeod Heminway, J., Does Sarbanes-Oxley Foster the Existence of Ethical Executive Role Models in the Corporation?, (2008), Journal of Business & Technology Law, Vol. 3, 221-242 at 235.

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Ibid. See Fiorelli, P., Will U.S. Sentencing Commission Amendments Encourage a New Ethical Culture Within Organizations?, (2004), 39 Wake Forest L. Rev. 565 at 573.

It is not possible to legislate people into good and ethical behaviour.<sup>868</sup> The existence of codes of conduct or codes of ethics is not sufficient without the involvement of the management team in the active implementation, effective monitoring, and enforcement of these codes. The role of the board of directors and executives is to set the appropriate ethical tone for the company and act as role models for all employees, demonstrating credibility and integrity on a daily basis.<sup>869</sup> Ethical leadership is connected with compliance. The more managers behave as ethical leaders' and role models, the more likely they are to influence the employees and gradually establish ethical behaviour.<sup>870</sup> Executives and directors must be role models whose behaviour mirrors the company's code of ethics. Ethics and values are matters of the feet and the heart, not just matters of the mouth.<sup>871</sup> Since the ethical culture starts at the top and is conveyed by example, directors and executives have a duty and the unique opportunity to reinforce their company's protection against fraud, mismanagement, and corruption. They must introduce and support a model that will influence operational practices in creating and sustaining an organizational culture that encourages ethical conduct and a commitment to compliance with the law.<sup>872</sup> Since ethics exists in corporate governance structures, an attempt will be made to define the concept of ethics in the context of corporate governance regulation and to outline the nature of an ethical corporate governance framework. The discussion will turn to examine the role of financial regulation.

### **The role of financial regulation**

The general effectiveness of the key financial regulations in the US, UK, and international initiatives should be reinforced, and the definition of regulatory models has become an issue in the analysis of financial scandals and is recognised as a theme of this theoretical background. The occurrence of the financial crisis raised concerns because of the re-

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Persaud, A.D. and Plender, J., *All you need to Know about Ethics and Finance: Finding a Moral Compass in Business Today*, Longtail Publishing Ltd, London, 2007, pg. 196-7.

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Mintz, S.M., *Corporate Governance in an International Context: Legal Systems, Financing Patterns and Cultural Variables*, (2005), 13 *Corporate Governance* 582 at 584. See Horber, F., *Presentation at the United Nations: Corporate Governance—Implementation, Challenges, and Trends* (Feb. 9, 2005); Petersen, L.E. and Krings, F., *Ethical Codes of Conduct and Employment Discrimination*, (2009), *Journal of Business Ethics* 85, 501–514.

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Petersen and Krings, *ibid.* at 510. See Brown, M. E. and Trevino, L. K., *Ethical Leadership: A Review and Future Directions*, (2006), *Leadership Quarterly* 17, 595–616.

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Freeman, R.E., *Create a New Story About Business: We Have a Unique Moment to Make a Lasting Difference in Corporate Practice. This is a Moment We Must Seize*, *Dirs. & Bds.*, Mar. 22, 2005, at 26.

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United States Sentencing Commission, 2004, available in the website: <http://www.ucdmc.ucdavis.edu/compliance/pdf/ussg.pdf> .

emergence of legal issues that had caused corporate and financial collapses during the last decade. A number of legal features put the events of the last decade in a league of their own. These can be identified with financial innovation and the abuse of capital market finance, premised in turn on a regulatory edifice shaped by the deregulation of the financial services industry.<sup>873</sup> Discussions following the 2008 crisis have pointed at regulatory failures and most importantly at the type of new infrastructure that should be in place.<sup>874</sup> This debate led to a deeper reflection on the role and rationale of regulation and on the politico-economic underpinnings that characterise different regulatory systems.<sup>875</sup> The debate results in a dichotomy reflected in two main ideological strands corresponding to a market system approach on one hand and a collectivist system approach on the other.<sup>876</sup> The former postulates that individuals should be left free to pursue their own welfare goals; regulation under this paradigm should have no significant role because the legal system can resort to instruments of private law to be implemented. The latter in contrast envisages the state to be better positioned to direct behaviours which, it is argued, would not occur without state intervention, because of intrinsic deficiencies in the market system to consider collective and public interests.<sup>877</sup>

Under market models, the law has a facilitative function as it provides individuals with a set of arrangements finalised at emphasising their welfare activities, whereby obligations are incurred voluntarily by individuals who can enforce their rights autonomously.<sup>878</sup> The scope of regulation can be defined as social, as opposed to economic. Social regulation finds its rationale in the public interest justification and it purports to protect society at large from

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The coincidence of these factors together can be said to result from the development of the regulatory framework in place over the last three decades. See C.R. Morris "The Trillion Dollar Meltdown. Easy Money, High Rollers, and the Great Credit Crash", New York Public Affairs 2008, p.xiv; Supra Deakin 2005.

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M. Arnold "Geithner warns of rift over regulation", Financial Times, Thursday March 11 2010; or N. Pratley "Can we have a new Glass-Steagall? Yes we can", guardian.co.uk, Thursday 21 January 2010.

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It is worth specifying that in this context regulation can be defined as "a sustained and focused control exercised by a public agency over activities that are valued by a community". See P. Selznick "Focusing Organizational Research on Regulation", in R. Noll "Regulatory Policy and the Social Sciences", 1985, p.363.

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A.I. Ogus "Regulation: Legal Form and Economic Theory", Hart Publishing London 2004, p.1-3.

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Ibid.

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Ibid. This dichotomy can be reflected in the "public interest theory of regulation" as opposed to the "private interest theory of regulation".

market failures.<sup>879</sup> This form of protection is guaranteed through a range of regulatory instruments which correspond to different degrees of state intervention. Economic regulation tends to have a more limited scope because its underlying assertion is that markets are more efficient than governments in imposing discipline and providing surveillance, without the costs associated with state intervention.<sup>880</sup> The friction between two diverging regulatory ideologies is reflected in the context of financial regulation, where the global and inter-connected character of financial markets and the lack of a concerted regulatory regime have magnified the centrality of the issue.<sup>881</sup> It is fair to say that the last quarter of the century has seen the emergence of liberal economists who advocated the benefits of a free-market regulatory system by identifying regulation as the source of financial crises of the 1980s and 1990s. It has been argued that regulatory interference into free-market contexts harms due diligence and monitoring incentives among market players because it creates an expectation that supervisors should provide control for institutions.<sup>882</sup>

Social regulation prioritises social welfare and in doing so it rejects assumptions upon which economic regulation is based, notably adequate information, competition, absence of externalities. The fact that these circumstances are not fulfilled leads, according to the theory, to market failures and this justifies a priori a case for regulatory intervention.<sup>883</sup> Within this regulatory context the different set of social goals flows into what is referred to as paternalistic regulation, premised on the assumption that information is insufficient and beyond that the decision-making process is affected by bounded rationality.<sup>884</sup> Such regulatory mechanism is based on the prescription of uniform directions and controls over

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Market failures are identified with the inadequate information available to individuals from the market, and with externalities that affect individuals who are not involved in transactions. Ibid.

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P.R. Wood "Law and Practice of International Finance", Sweet and Maxwell London 2008, ch.21; *ibid* p.5. It is suggested that the main function of economic regulation is to provide a substitute of competition in cases of natural monopolies.

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K. Alexander, R. Dhumale, J. Eatwell "Global Governance of Financial Systems – The International Regulation of Systemic Risk", OUP 2006, ch.1.

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C. Goodhard, P. Hartman, D. Llewellyn, L. Rojas-Suarez, S. Waisbrod "Financial Regulation – Why, How and Where Now?", Routledge Oxford 1998, p.2,3.

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Supra Ogus 2004, p.30.

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Ibid p.51. Paternalism is defined as the interference with a person's liberty of action, justified by the interest and welfare of the person being coerced. When the justification resides in the impact of the individual's action on others, this would fall under the concept of externalities.



certain activities which would lead to market failure and to harm for society at large. From a regulatory perspective, the endorsement of a free-market ideology entailed the unrestrained application of market discipline mechanisms. These resulted in the self-regulatory character of the industry and in particular of certain regulatory agencies and international fora<sup>885</sup>; the incentive within the industry to innovate in order to adjust the risk profile of both assets and liabilities on the balance sheet<sup>886</sup>; and the employment of disclosure as regulatory tool. Arguments surrounding these models have become particularly<sup>887</sup> intense in the aftermath of the global crisis.

## Self-regulation

Under market discipline, market forces would be sufficient to direct and correct behaviours, without the need for external regulatory intervention. This proposition has been reflected in self-regulation, a regulatory technique that implemented the principle of subsidiarity which allowed state intervention only if market participants were not able to find adequate solutions within the market itself, and pushed states out of the regulatory scene.<sup>888</sup> Self-regulation can be understood as a system of private governance, where the self-interest of market participants in a capitalist system allows the invisible hand to work as they devise acceptable rules and behaviours.<sup>889</sup> From the perspective of market participants, self-regulation represents a cost-effective technique and a prospect of avoiding burdensome government regulation. Expertise of the industry from which rules underpin is another element that enhances the quality of this regulatory process. The strength of self-regulation is the applicability of the resulting rules across national borders, because they are defined by contracts and are not restricted by jurisdictional limits.<sup>890</sup> The weaknesses of self-regulation

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Supra Ogus 2004 p.8; and E. Hupkes “Regulation, Self-regulation or Co-regulation”, 427 Journal of Business Law 2009.

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A.W. Mullineux “Financial Innovation and Social Welfare”, 243 Journal of Financial Regulation and Compliance 2010, p.244.

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E. Avgouleas “The Global Financial Crisis and the Disclosure Paradigm in European Financial Regulation: The Case for Reform”, 6 European Company and Financial Law Review 2009, p.1.

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Supra Weber 2009, p.657.

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A. Smith “An Inquiry into the Nature and Causes of the Wealth of Nations”, 1776, available at [www.adamsmith.org/smith/won-index.htm](http://www.adamsmith.org/smith/won-index.htm).

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Supra Hupkes 2009 p.429.

are associated with the danger of ceding too much to market participants' discretion in a way that could favour their own interests over the public good.<sup>891</sup> Above and beyond intrinsic conflicts of interest that can affect the legislative process, self-regulatory systems suffer from the lack of adequate enforcement, because the industry may not be effective at enforcing rules. This derives from the very character of these rules, which are not binding, as they result from negotiation among industry members, who adopt these rules on a voluntary basis.<sup>892</sup> Self-regulation has been a central feature in the financial industry, both in the City of London and in the US, where securities regulation enacted after the 1929 Great Crash set a regulatory framework that relied on and recommended self-regulation.<sup>893</sup> In the UK, the Financial Services Authority (FSA) established in 2000<sup>894</sup> similarly set a regulatory infrastructure based on both binding rules and principles, complemented through industry guidance.<sup>895</sup> Many countries adopt self-regulatory arrangements of their stock exchanges, whereby self-regulatory organisations have been established in order to set standards and govern members' activities, while providing mechanisms for sanctioning members for violations.<sup>896</sup>

## Corporate Governance Regulation

Failures in corporate governance practices were considered responsible for the Russian debt default and the Asian financial crisis in 1998 according to World Bank's Reports on Observance of Standards and Codes (ROSC).<sup>897</sup> After experiencing the systemic effects of

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<sup>891</sup>

Ibid p.430. This criticism is coupled with problems like conflicts of interest between self-regulatory bodies and other market participants; with competitive distortions; with insufficient scope of rules for third parties and for public interest.

<sup>892</sup>

Supra Weber 2009, p.658. What this means is that enforcement measures will be contractual and will not consist in real sanctions like in the case of state laws.

<sup>893</sup>

Supra Hupkes 2009, p.428.

<sup>894</sup>

Financial Services and Markets Act 2000.

<sup>895</sup>

Industry guidance is defined as information created, developed and freely issued by a person or body, other than the FSA, which is intended to provide guidance from the body concerned to the industry about the provisions of the FSA Handbook. See [www.fsa.gov.uk/Pages/handbook/](http://www.fsa.gov.uk/Pages/handbook/)

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S. Gadinis and H.E. Jackson "Markets as Regulators: A Survey", Southern California Law Review, Vol.80,1239, 2007, p.1244.

<sup>897</sup>

such failures, the G7 leaders added the corporate behaviour and incentives to their priority list.<sup>898</sup> Shortly after that (mid-1999), the Organization for Economic Cooperation and Development (OECD) adopted a set of principles which were updated in 2004.<sup>899</sup>

## Corporate Governance Regulations and Guidelines

### OECD Principles of Corporate Governance

#### Ensuring the basis for an effective corporate governance framework

The corporate governance framework should protect and facilitate the exercise of shareholders' rights. It is expected that different countries experience the agency and corporate governance problems differently. Using the legal system find that countries with better legal protection for shareholders tend to have more dispersed ownership. From this it can be deduced that large shareholders are a market response to weak legal protection provided by law. It is identified as a potential corporate governance problem the risk of outsiders being expropriated by insiders. This means that managers and large shareholders can collude and jointly exploit minority shareholders. It can be argued the following OECD principle was devised. The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights. It is far more complex exercise involving employees, suppliers, general public, environment and many more which are considered to be the stakeholder group. Involving a single stakeholder in this process, even if this stakeholder represents employees<sup>900</sup>, will add a lot to the complexity of governing the corporations. Weil et al. (2002) report states that the largest difference in corporate governance practices among European Union member states is related to the position of employees in corporate governance, a difference often embedded in law.

The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. The famous Enron and Parmalat corporate scandals which happened in

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[http://www.worldbank.org/ifa/rosc\\_cgoverview.html](http://www.worldbank.org/ifa/rosc_cgoverview.html).

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[http://www.worldbank.org/ifa/rosc\\_cgoverview.html](http://www.worldbank.org/ifa/rosc_cgoverview.html).

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<http://www.oecd.org/dataoecd/32/18/31557724.pdf>.

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Or miners, if one wants to be consistent with the previous example.

2001 and 2003 respectively, is said to have been caused by the lack of transparency and disclosure.

## **The Responsibilities of the Board**

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. The OECD principles are designed to guide companies regarding their corporate governance practices. A similar approach but aimed at countries is used by the European Bank for Reconstruction and Development (EBRD). In September of 1997 EBRD published their guidelines for corporate governance named Sound Business Standards and Corporate Practices.<sup>901</sup> Helping companies and governments understand the broader concerns of lenders and investors is the objective of these guidelines.<sup>902</sup> In the same year, EBRD published 10 core principles<sup>903</sup> which evaluate the corporate governance framework (CGF). These principles which are based on international best practices and standards can help in assessing a country's CGF in estimating the need for reform. The EBRD principles are designed as guidelines with the purpose to identify the aims to be achieved rather than outlining the process by which to achieve these aims. Another document produced by EBRD, 'principles of corporate governance and corporate governance checklist',<sup>904</sup> offers countries a tool to evaluate and improve their corporate governance practices through 70 questions divided into five groups.<sup>905</sup> EBRD has gathered data using this checklist in all transition countries and rated the results from fully-conforming, strongly-, weakly- to non-conforming. The Legal Transition Programme Review<sup>906</sup> - report published in June 2012 presents the impact of the legal transition programme during the period 2001-2010 in the countries that EBRD operates.

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<http://www.ebrd.com/downloads/research/guides/standards.pdf>

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EBRD claims that these guidelines preceded the OECD Corporate Governance Principles.

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<http://www.ebrd.com/downloads/legal/corporate/cgprin.pdf>

904

Template available at: <http://www.ebrd.com/downloads/legal/corporate/checklst.pdf>

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These five groups are identical to OECD corporate governance principles II-VI. Because the EBRD checklist document was produced in 2000 it is assumed that this is the main reason why the first OECD corporate governance principle was not included.

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Available at: [www.ebrd.com/downloads/about/evaluation/121109legal.pdf](http://www.ebrd.com/downloads/about/evaluation/121109legal.pdf)

## Reform monetary policy

With so many market-driven methods of debt financing available, it can be argued that the Federal Reserve Board has much less power these days- as it raises and lowers its overnight discount rate to member banks – upon financial markets. The Fed is an independent agency.<sup>907</sup> The flurry of asset-consuming mergers and acquisitions is being funded by this gap. The board are going to have to justify it to the shareholders. The net cost of corporate borrowing, after corporations deduct interest expense on their tax returns, is below four percent. The average earnings/price yield on the S&P is about six percent. When people invest in these deals, without borrowing the money to do so, it is harmless enough. A dollar moves from a less productive investment to, one would hope, a more productive investment. Because they may lend a multiple of their deposits, their loans create more dollars in the marketplace. They expand the credit markets. While a weaker dollar helps exports, credit expansion is really an expensive way to subsidize those exports.

## Duties of Directors

Acting within their powers<sup>908</sup>: directors are strictly charged to exercise their powers only for a proper purpose. In duties of directors, there are not all breaches of duty can be ratified, as some are not capable of being ratified. The members of the company are permitted to ratify transactions. It is largely accepted in most jurisdictions that this should be capable of being abrogated by the company's constitution.

Directors must exercise their powers for a proper purpose. While in many instances an improper purpose is readily evident, such as a director looking to feather his or her own nest or divert an investment opportunity to a relative, such breaches usually involve a breach of the director's duty to act in good faith.<sup>909</sup> An incidental result that a shareholder lost his majority, or a takeover bid was defeated would not itself make the share issue improper. Markets for corporate control should be allowed to function in an efficient and transparent manner. The rules and procedures governing the acquisition of corporate control in the capital markets, and extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be articulated and disclosed so that investors understand their rights and recourse. A director of a company must in any given case act in the way he decides, in good faith, would be the most likely to promote the success of the company for the benefit of its members as a whole; and in deciding what would be most likely to promote

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Through appointments to the Board, and by public and private persuasion from the Presidential pulpit, an active President can and should exert significant influence on monetary policy.

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s.171 CA 2006

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Greater difficulties arise where the director, while acting in good faith, is serving a purpose that is not regarded by the law as proper.

that success, take account in good faith of all the material factors that it is practicable in the circumstances for him to identify.<sup>910</sup> To impose liability on directors for making a wrong business decision would cripple their ability to earn returns for investors by taking business risks. This kind of judicial guessing is what the business judgment rule was designed to prevent.<sup>911</sup>

Directors' duties under the common law can be divided into a duty to act carefully and with a certain degree of skill. The courts may permit the company, acting by a majority in general meeting, to forgive directors who have acted in any of the ways. The ease with which this will be allowed depends on the view taken by the court of the seriousness of the behavior. The court has a power to release a director from the consequences of a breach of duty where he has acted honestly and reasonably and ought, in all the circumstances of the case, to be excused.<sup>912</sup> Directors owe their duties to the company and the company is the proper plaintiff in an action to enforce such duties.<sup>913</sup> If such a rule were absolute, the majority would have an absolute right to defraud the minority. Exceptions to the rule have been made. Whether the individual shareholders can sue or, whether the majority can prevent the action and forgive the directors depends on the depravity of the wrongdoing in question. An oppressed minority have a wide and flexible action which is procedurally simpler.<sup>914</sup>

## Regulatory Regime

Having discussed some of the common origins of banking distress, we turn to consider a set of principles to reduce the future probability of crises. In the analysis, regulation is about changing the behaviour of regulated institutions. One of the key questions is the extent to which behaviour is to be altered by externally imposed rules, or through creating incentives for firms to behave in a particular way.<sup>915</sup>

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Trade and Industry Committee, The White Paper on Modernising Company Law, London, July 2002, p8, Cm 5553-I, part I, para 3, available in the website: <http://www.publications.parliament.uk/pa/cm200203/cmselect/cmtrdind/439/439.pdf>.

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Pritchard, A.C., 'London as Delaware', (2009), University of Cincinnati Law Review, forthcoming; University of Michigan Law & Economics, Olin Working Paper No. 09-008, available in the website: <http://ssrn.com/abstract=1407610>.

<sup>912</sup>

s. 727 Companies Act 1987

<sup>913</sup>

This is known as the rule in *Foss v Harbottle*.

<sup>914</sup>

ss. 459-61 Companies Act 1985 as amended by Companies Act 1989.

<sup>915</sup>

Regulation is the set of rules and standards that govern financial institutions; their objective is to foster financial stability and to protect the customers of financial services. Supervision is the process designed to oversee financial institutions in order to ensure that rules and standards are properly applied.<sup>916</sup> The case for regulation of banks depends on various market imperfections and failures, which in the absence of regulation, produce sub-optimal results and reduce consumer welfare. In other words, the objective of regulation should be limited to correcting identified market imperfections and failures:

(1) The objectives of regulation need to be defined and circumscribed. Financial regulation should have a limited number of objectives. In the analysis the objectives are to sustain systemic stability and to protect the consumer.

(2) The rationale of regulation and supervision should be limited. The rationale for regulation lies in correcting for identified market imperfections and failures; incorporating externalities; the economies of scale in monitoring, breaking a grid lock, and limiting moral hazard associated with safety nets.

(3) Regulation should be seen in terms of a set of contracts. Laws, regulations, and supervisory actions provide incentives for regulated firms to adjust their actions and behaviour, and to control their own risks internally. There need to be incentives for the regulator to set appropriate objectives, to adopt well-designed rules, not to over-regulate, and to act in a timely fashion. If incentive contracts are well-designed they will induce appropriate behaviour by regulated firms. Conversely, if they are badly constructed and improperly designed, they might fail to reduce systemic risk or have undesirable side effects on the process of financial intermediation.<sup>917</sup>

(4) The form and intensity of regulatory and supervisory requirements should differentiate between regulated institutions according to their relative portfolio risk and efficiency of internal control mechanisms. One of the hazards of a detailed and prescriptive rulebook approach is that it may fail to make the necessary distinctions between non-homogeneous firms because the same rules are applied to all. It reduces the scope for legitimate differentiations to be made. The adoption of an internal model's approach, such has been introduced by G-20 countries after the Market Risk Amendment of the Basle Accord, recognises this point.<sup>918</sup>

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The arguments against reliance on detailed and prescriptive rules are outlined in Goodhart, et.al. (1998).

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Report of High Level Group on Financial Supervision in the EU, (2009), Brussels, available in the website: [http://ec.europa.eu/internal\\_market/finances/docs/de\\_larosiere\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf).

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At centre stage is the issue of whether all parties have the right incentives to act in a way that satisfies the objectives of regulation.

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(5) In some areas the regulator could offer a menu of contracts to regulated firms requiring them to self-select into the correct category. There is an information, and possibly efficiency loss, if a high degree of conformity in the behaviour of regulated firms is enforced.

(6) Capital regulation should create incentives for the correct pricing of absolute and relative risk.

### **Incentive structures**

Emphasis has been given to the central importance of incentives within banks and the role that regulation can have in positively creating appropriate incentives. As banking crises frequently occur when there are weak incentives to act prudently, a necessary ingredient of a robust and stable financial system is the creation of appropriate and efficient incentives and disciplining mechanisms for all market participants and most especially bank owners, bank managers and financial system supervisors.<sup>919</sup>

(1) There should be appropriate incentives for bank owners

Bank owners have an important role in the monitoring of bank management and their risk-taking. It is bank owners who absorb the risks of the bank. There are several ways in which bank owners can be appropriately incentivised.

(2) There should be appropriate internal incentives for management

Creating the right incentive structures for the managers of financial institutions is equally as important as those for the owners. In the analysis, all aspects of the behaviour of a firm are corporate governance issues. There are several procedures, processes and structures that can reinforce internal risk control mechanisms. Supervisors can strengthen the incentives for these by, for instance, relating the frequency and intensity of their supervision and inspection visits to the perceived adequacy of the internal risk control procedures, and compliance arrangements.<sup>920</sup>

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Other considerations that should govern the setting of minimum capital adequacy requirements for individual banks include the quality of management; the quality, reliability and volatility of the bank's earnings; and the bank's liability and liquidity profile.

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These are briefly considered: (Llewellyn, 1999)

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Regulators can create appropriate incentives by calibrating the external burden of regulation to the quality of management and the efficiency of internal incentives.



### **Specific measures designed to create correct incentive structures include:**

a. Strong and effective risk analysis, management and control systems in place in all financial institutions for assessing risks ex ante, and asset values ex post. This includes systems and incentives are required for timely and accurate provisioning against bad or doubtful debts. Regulatory agencies have a powerful role in promoting, and insisting upon, effective systems of internal management and risk control in financial institutions by strict accountability of owners, directors and senior management. Managers should lose if the bank fails.<sup>921</sup>

b. Mechanisms need to be in place to ensure that loan valuation, asset classification, loan concentrations, inter-connected lending, and risk assessment practices reflect sound and accurate assessments of claims and counterparties. This requires mechanisms for the independent verification of financial statements and compliance with the principles of sound practice through professional external auditing and on-site inspection by supervisory agencies. Ownership structures that foster shareholder monitoring and oversight should be encouraged. This includes private ownership of banks to strengthen the monitoring of management performance and to reduce distortions in incentives for managers. Large banks should be required to establish internal audit committees. The key is that there needs to be appropriate internal incentives for management to behave in appropriate ways, and the regulator has a role in ensuring internal incentives are compatible with the objectives of regulation.

Corporate governance matters are covered in the Dodd-frank legislature in the United State including new SEC rules pertaining to various corporate governance issues as well as some changes in banking regulations. New corporate governance and Corporate Stewardship Codes are introduced in the United Kingdom including some changes in banking regulations affecting corporate governance matters.

### **Legislative response and passage**

The bills that came after Obama's proposal were largely consistent with the proposal, but contained some additional provisions and differences in implementation.<sup>922</sup> The Volcker Rule was not included in Obama's initial June 2009 proposal, but Obama proposed the rule later in January 2010, after the House bill had passed. The rule, which prohibits depository banks from proprietary trading similar to the prohibition of combined investment and commercial banking in the Glass-Steagall Act, and the conference committee enacted the

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<sup>921</sup>

<sup>921</sup> This requires a high degree of professionalism in bank managers and decision-makers and penalties for incompetence amongst bank managers. Remuneration packages may be related to regulatory compliance.

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<sup>922</sup> "Side-by-Side Comparison Chart – Key Senate and House Bill Issues" ([http://www.pewfr.org/reform\\_resources\\_detail?id=0877](http://www.pewfr.org/reform_resources_detail?id=0877)). Pew Financial Reform Project. Davis Polk & Wardwell.

rule in a weakened form, Section 619 of the bill, that allowed banks to invest up to 3% of their Tier 1 capital in private equity and hedge funds<sup>923</sup> as well as trade for hedging purposes.

The version of the bill passed the House along party lines in December by a vote of 223–202, and passed the Senate with amendments in May 2010 with a vote of 59–39 along party lines. The bill moved to conference committee, where the Senate bill was used as the base text<sup>924</sup> although a few House provisions were included in the bill's base text.<sup>925</sup> The Durbin Amendment gave the Federal Reserve the power to regulate debit card interchange fees, and the Fed proposed a maximum interchange fee of 12 cents per debit card transaction, which cardhub.com estimated would cost large banks \$14 billion annually. On June 29, 2011, the Fed issued its final rule, which holds that the maximum interchange fee an issuer can receive from a debit card transaction is 21 cents plus 5 basis points multiplied by the amount of the transaction. This rule allows issuers to raise their interchange fees by as much as one cent if they implement certain fraud-prevention measures. An issuer eligible for this adjustment, could receive an interchange fee of as much as 24 cents for the average debit card transaction, according to the Federal Reserve. This cap which took effect on October 1, 2011, rather than July 21, 2011, as was announced will reduce fees roughly \$9.4 billion annually. As a result of the government limiting their revenue from interchange fees, banks made plans to raise account maintenance fees to compensate.<sup>926</sup> The New York Times published a comparison of the two bills prior to their reconciliation. On June 25, 2010, conferees finished reconciling the House and Senate versions of the bills and four days later filed a conference report. The conference committee changed the name of the Act from the "Restoring American Financial Stability Act of 2010."

Prior to the passage of Dodd–Frank, investment advisers were not required to register with the SEC if the investment adviser had fewer than 15 clients during the previous 12 months and did not hold itself out to the public as an investment adviser. The act eliminates that

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Indiviglio, D. (2010). "Congress' Conference Committee Completed for Financial Reform" (<http://www.theatlantic.com/business/archive/2010/06/congress-conference-committee-completed-for-financial-reform/58718>). The Atlantic.

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"Senate Passes Landmark Financial Reform Bill" (<http://washingtonindependent.com/91650/senate-passes-landmark-financial-regulatory-reform-bill>). Washington Independent.

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"Congress Starts to Merge Financial Reform Bills" (<http://dealbook.blogs.nytimes.com/2010/06/11/congress-starts-to-merge-financial-reform-bills>). New York Times.

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"New fees for banks likely to mean new fees from banks – Timesonline.com: Local News". ([http://www.timesonline.com/news/local\\_news/new-fee-for-banks-likely-to-mean-new-fees-from/article\\_9d295744-af8f-5eea-bbe1-a33ac5200f52.html](http://www.timesonline.com/news/local_news/new-fee-for-banks-likely-to-mean-new-fees-from/article_9d295744-af8f-5eea-bbe1-a33ac5200f52.html)) Timesonline.com.

exemption, thereby rendering numerous additional investment advisers, hedge funds, and private equity firms subject to new registration requirements. Certain non-bank financial institutions and their subsidiaries will be supervised by the Fed in the same manner as if they were a bank holding company.<sup>927</sup> It is suggested that that Dodd–Frank is not strong enough, arguing that it fails to protect consumers adequately, and does not end too big to fail.<sup>928</sup> The Securities Industry and Financial Markets Association - the top Wall Street lobby - has expressed support for the law, and has urged congress not to change or repeal it in order to prevent a stronger law from passing.<sup>929</sup> Bankruptcy expert David Skeel concluded that the law has two major themes which are government partnership with the largest Wall Street banks and financial institutions and a system of ad hoc interventions by regulators that are divorced from basic rule-of-law constraints. While he states that the overall pattern of the legislation is disturbing, he concludes that some are clearly helpful, such as the derivatives exchanges and the Consumer Financial Protection Bureau.<sup>930</sup>

In terms of the impact on the federal budget, the CBO estimates that deficits would reduce between 2011–2020, but in part due to the risk-based assessment fees levied to initially capitalize the Orderly Liquidation Fund; after which, the majority of revenue for the fund would be drawn primarily from interest payments. The CBO points out that the reclassification of collected fees by various government agencies has the effect of boosting revenue. The cost estimate raises questions about the time-frame of capitalizing the Fund - their estimate took the projected value of fees collected for the Fund weighed against the expected expense of having to deal with corporate defaults until 2020. Their conclusion was it would take longer than 10 years to fully capitalize the Fund, although no specifics beyond that were expressed. The projection was a \$5 billion or more deficit increase in at least one of the ten-year periods starting in 2021. As of the beginning of June 2013, 175 of 279 passed Dodd-Frank deadlines have been missed, while only 104 deadlines have been met with finalized rules. Of the 398 total Dodd-Frank rulemaking requirements, regulators have

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To the extent that the Act affects all federal financial regulatory agencies, eliminating the Office of Thrift Supervision and creating Financial Stability Oversight Council and the Office of Financial Research in addition to several consumer protection agencies, including the Bureau of Consumer Financial Protection, this legislation represents a change in the way America's financial markets will operate in the future.

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Morgenson, Gretchen (June 25, 2010), "Strong Enough for Tough Stains?", The New York Times.

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Carney, Timothy (2011-02-13) Wall Street lobbyists to GOP: Hands off Dodd–Frank, Washington Examiner

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Skeel, David 2010. The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences. Hoboken NJ: John Wiley & Sons.

missed 70.1 percent of rulemaking deadlines and 99.6 percent of 280 rules with specified deadlines. Regulators have to release proposals for 64 of the 175 missed rules.<sup>931</sup>

The Dodd-Frank legislation makes it harder for banks to avoid liability under state law by making it more difficult for them to raise the preemption argument. The [Dodd-Frank Wall Street Reform and Consumer Protection Act](#), signed into law in 2010, seeks to tighten the reins on national banking institutions by strengthening the legal standards for the preemption of state laws, thereby making it harder for banks to avoid liability under state law. When the defense of preemption is asserted and found applicable, the effect is dismissal of the entire claim at issue. Dodd-Frank has added various obstacles that must be overcome before a bank can claim the protection of preemption. In order to minimize the harsh effect of Dodd-Frank's new rules, banks should make an effort to frame their preemption arguments before courts in ways that result in favor of preemption. However, global regulatory co-operation would be threatened if the US dismantled its regime for failing banks.<sup>932</sup>

The 2008 financial crisis, as Ceresney comments, will be known as the modern financial system's annus horribilis.<sup>125</sup> A natural consequence of a crisis is that citizens are asking angrily how this happened and who is to blame.<sup>933</sup> This invites the enquiry that amidst this wreckage, as legislators consider proposals for sweeping regulatory reforms, prosecutors and regulatory agencies have begun the arduous and time-consuming process of determining whether any criminal wrongdoing led to the credit crisis.<sup>934</sup> The outcome of this soul searching was: The Dodd-Frank Wall Street Reform and Consumer Protection Act [DoddFrank]<sup>935</sup> which set out to reshape the U.S. regulatory system in a number of areas including but not limited to consumer protection, trading restrictions, credit ratings, regulation of financial products, corporate governance and disclosure, and transparency.<sup>936</sup> The introduction to Dodd-Frank makes clear what the legislation's intentions were: to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end too big to fail, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for

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Villarreal, Alexandra (June 7, 2013). "Regulators miss 70.1 percent of 398 Dodd-Frank rules". Bank Credit News.

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Financial Times (24 April 2017), "UK watchdog warns Trump over scrapping rules on failing banks".

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Ceresney, Eng and Nuttall (n 63) 225.

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Ceresney, Eng and Nuttall (n 63) 225.

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12 USC § 5322, which amends the Securities Exchange Act 1934.

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US Securities and Exchange Commission, 'The Laws that Govern the Securities Industry'. <http://www.sec.gov/about/laws.shtml#df2010>.

other purposes.<sup>937</sup> One particular aspect of Dodd-Frank, the Volcker Rule, which prohibits a bank from engaging in proprietary trading, and from acquiring or retaining an ownership interest in a hedge fund or private equity fund.<sup>938</sup> The intent of the Volcker Rule was to endeavour to replicate ‘The US Banking Act of 1933, called the GlassSteagall Act after its sponsors, which separated investment banking from retail banking by limiting the range and volume of securities-related transactions that the commercial entities could perform.’<sup>939</sup> This rule does not merely affect US entities but also applies to foreign banks and entities which have a branch or agency in the US and clearly demonstrates the reach of US legislation.<sup>940</sup>

An additional outcome of the review of the financial crisis was that the SEC recognised that more information on breaches of securities law was required and has caused it to promote the role of the whistleblower.<sup>941</sup> Dodd-Frank encourages whistleblowers to report suspected violations direct to the SEC ‘Office of the Whistleblower’,<sup>942</sup> which will reward<sup>943</sup> such suppliers of information who are eligible to receive between 10 percent and 30 percent of any enforcement penalty in excess of \$1 million that the agency ultimately recovers as a

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‘Dodd-Frank Wall Street Reform and Consumer Protection Act.’  
Preamble. <http://www.gpo.gov/fdsys/pkg/BILLS-111hr4173enr/pdf/BILLS-111hr4173enr.pdf>.

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The Dodd–Frank Wall Street Reform and Consumer Protection Act 2010, s 619. ‘The Volcker Rule is named after its main sponsor, Paul Volcker, who is a former Chairman of the Board of Governors of the Federal Reserve System and an economic adviser to the President of the USA, Barack Obama’. Graeme Baber, ‘A critical examination of the legislative response in banking and financial regulation to issues related to misconduct in the context of the crisis of 2007-2009’ (2013) 20(2) JFC 237.

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Baber (n 131) 237.

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William E Stern, ‘Impact of the Volcker rule and related Dodd-Frank Act requirements on fund sponsors affiliated with non-US banking organisations’ (2013) 4 JIBFL 229.

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‘Means any individual, or 2 or more individuals acting jointly, who provides information relating to a violation of this Act to the Commission, in a manner established by rule or regulation by the Commission’ Dodd-Frank Act 2010, s 748(7).

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The SEC established the ‘Office of the Whistleblower’, stating that the ‘new whistleblower program is a part of our effort to enhance the agency’s capacity to detect and prevent fraud’. US Securities and Exchange Commission, ‘Speech by SEC Chairman: Opening Statement at SEC Open Meeting: Item 2 — Whistleblower Program’ 25 May 2011. <http://www.sec.gov/news/speech/2011/spch052511mls-item2.htm>.

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‘In addition to providing qualifying whistleblowers with a bounty, the Dodd-Frank Act protects whistleblowers in two other respects. First, it allows whistleblowers to remain anonymous up to the point of receiving their financial awards. Second, the Dodd-Frank Act allows whistleblowers to redeem their bounties unless they are convicted of a crime related to the reported FCPA violations’ Hansberry (n 16) 195.

result of the report.’<sup>944</sup> The largest reward was \$30m in 2014.<sup>945</sup> Dodd-Frank was not the first attempt at encouraging informers to come forward with information about fraud against the US government in return for a share of the damages recovered.<sup>946</sup> In 1863, pre-dating both conspiracy to defraud (1867) and Mail Fraud (1872), the False Claims Act empowered citizens to sue on behalf of the government for fraud against the government and share in the fruits of litigation: since 2009, the DoJ has recovered more than \$13.3 billion in False Claims Act cases.<sup>947</sup> In 2012, the DoJ brought an all-time high of 647 whistleblower cases,<sup>948</sup> thus demonstrating the economic value of an incentivised whistleblower. The rewards from SEC clearly make it all the more likely that employees who notice such wrongdoing will take steps to bring it to light. This may be at the expense of reporting through companies’ internal corporate risk management or governance channels. The SEC reported receiving one to two high value tips per day, up from about a dozen a year prior to enactment of Dodd-Frank.<sup>949</sup> There is the risk of repeat bad faith claims as in a 2014 case where the SEC banned an individual who had knowingly made 196 award applications which were false, fictitious or fraudulent in pursuit of an award.<sup>950</sup> In noting the effect of Dodd-Frank, it is clear that the US has a long history of providing incentives. This is not a feature of UK culture and legislation, including the UK Bribery Act 2010, does not provide for these rewards.<sup>951</sup> The UK regulators FCA/PRA have announced proposals to make regulatory changes necessary to require firms to have effective whistleblowing procedures, and to make senior management

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These percentages are typical when compared with other statutes with similar whistleblowing provisions, such as IRS Whistleblower Act and False Claims Act. Hansberry (n 16) 195. Welu (n 11). Robert S Bennett, Hilary Holt LoCicero and Brooks M Hanner, ‘From Regulation to Prosecution to Cooperation: trends in Corporate White Collar Crime Enforcement and the Evolving role of the White Collar Criminal Defense Attorney’, (2013) 68 The Business Lawyer 411.

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Securities and Exchange Commission, ‘SEC Announces Largest-Ever Whistleblower Award’. <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543011290#.VCktK77HthY>.

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Carr (n 37)368

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Department of Justice, ‘Justice Department Recovers , Billion in False Claims Cases in Fiscal Year 2009; More Than \$24 Billion Since 1986’ 19 November 2009. <http://www.justice.gov/opa/pr/2009/November/09-civ1253.html> accessed 4 June 2013. ‘\$9.5 billion of those recoveries are from cases involving fraud against federal health care programs. Money goes back to the federal agency that was defrauded, replenishing federal funds and sending a message to potential scammers that ultimately they will be required to pay up to three times the amount of their fraud.’ Department of Justice. ‘Accomplishments under the leadership of Attorney General Eric Holder’ <http://www.justice.gov/accomplishments/> .

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Department of Justice, ‘Accomplishments under the leadership of Attorney General Eric Holder’ (n 141).

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Hansberry (n 16) 195.

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Securities and Exchange Commission, ‘Final Order’ <http://www.whistleblowerdefense.com/files/2014/06/Final-Order7.pdf> .

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Chris Warren-Smith, ‘Regulatory: The year ahead’ (2011) 161 NLJ 358.

accountable for delivering these,<sup>952</sup> but concluded that financial incentives to report would not be adopted.<sup>953</sup> This area is outside the scope of this thesis but would warrant further research because of the risk of regulatory arbitrage where, for UK companies falling within the purview of the SEC, whistleblowers may be tempted to report wrongdoing in the US rather than either the UK authorities or through internal procedures, where no rewards exist.<sup>954</sup>

Some eight years before Dodd-Frank, in the wake of a spate of financial scandals,<sup>955</sup> Sarbanes-Oxley Act 2002 was enacted to protect Investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.<sup>956</sup> This was a congressional response to revelations of several high profile accounting fraud cases including Enron, WorldCom, Tyco, that resulted in mass destruction of investor value and loss of investor confidence in the integrity of the financial markets.<sup>957</sup> As Yeager notes, these cases led to criminal charges of company officials and the bankruptcy of Arthur Andersen LLP, at the time arguable the most prestigious independent auditing firm in the world.<sup>958</sup> A key feature of Sarbanes-Oxley was provision for whistleblowers: firstly, anti-retaliation measures, which involves protecting whistleblowers from employer retaliation after they disclose wrongdoing;<sup>154</sup> secondly, reporting arrangements which requires that corporations provide employees with a standardized channel to report organizational misconduct within the corporation.<sup>155</sup> A further feature of Sarbanes-Oxley was increased sentences: the maximum penalty for wire and mail fraud from five years to twenty years imprisonment.<sup>156</sup> This can be compared with the UK Fraud Act 2006 maximum of ten years.<sup>157</sup>

## U.S. Securities and Exchange Commission

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Financial Conduct Authority, 'Financial Incentives for Whistleblowers. Note by the Financial Conduct Authority and the Prudential Regulation Authority for the Treasury Select Committee' <http://www.fca.org.uk/static/documents/financial-incentives-for-whistleblowers.pdf>.

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Financial Conduct Authority, 'Financial Incentives for Whistleblowers' (n 157).

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Hansberry (n 16) 195.

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For example, Enron, Worldcom, Tyco, Arthur Andersen. Fred Yeager and others, 'US legislation designed to improve corporate governance: an exploration' (2010) 33(1) Co Law 25.

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Sarbanes-Oxley Act of 2002. Preamble. <http://www.sec.gov/about/laws/soa2002.pdf>.

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Yeager (n 150) 25.

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Yeager (n 150) 25.

The U.S. Securities and Exchange Commission (SEC) is an [agency of the United States federal government](#). It holds responsibility for enforcing the federal [securities](#) laws and regulating the securities industry, the nation's stock and options exchanges, and other electronic securities markets in the United States.<sup>959</sup> The enforcement authority given by congress allows the SEC to bring civil enforcement actions against individuals or companies alleged to have committed [accounting fraud](#), provided false information, or engaged in [insider trading](#) or other violations of the [securities law](#). Corporation Finance is the division that oversees the disclosure made by public companies, as well as the registration of transactions, such as mergers, made by companies. The division is responsible for operating EDGAR. The Trading and Markets division oversees self-regulatory organizations such as the [Financial Industry Regulatory Authority](#) (FINRA) and MSRB and all [broker-dealer](#) firms and [investment houses](#). This division interprets proposed changes to regulations and monitors operations of the industry. The SEC delegates most of its enforcement and rulemaking authority to FINRA. All trading firms not regulated by other SROs must register as a member of FINRA. Individuals trading securities must pass exams administered by FINRA to become [registered representatives](#).<sup>960</sup>

The Investment Management Division oversees registered investment companies, which include [mutual funds](#), as well as registered [investment advisors](#). These entities are subject to extensive regulation under various federal securities laws.<sup>961</sup> The Division of Investment Management administers various federal securities laws, in particular the Investment Company Act of 1940 and Investment Advisers Act of 1940. The SEC's staff may seek voluntary production of documents and testimony, or may seek a formal order of investigation from the SEC, which allows the staff to compel the production of documents and witness testimony. The SEC can bring a [civil action](#) in a [U.S. District Court](#), or an [administrative proceeding](#) which is heard by an independent [administrative law judge](#) (ALJ). The SEC does not have criminal authority, but may refer matters to state and federal prosecutors. The director of the SEC's Enforcement Division [Robert Khuzami](#) left the office in February 2013.<sup>962</sup>

## Regulatory action in the credit crunch

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[A-Z Index of U.S. Government Departments and Agencies](#) USA.gov

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["National Association of Securities Dealers"](#). Finra.com.

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Lemke and Lins, Regulation of Investment Advisers (Thomson West, 2013 ed.); Lemke, Lins and Smith, Regulation of Investment Companies (Matthew Bender, 2013 ed.).

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Proteas, Ben. ["S.E.C.'s Revolving Door Hurts Its Effectiveness, Report Says"](#). Dealbook.nytimes.com.



The SEC announced on September 17, 2008, strict new rules to prohibit all forms of [naked short selling](#) as a measure to reduce volatility in turbulent markets.<sup>963</sup> The SEC investigated cases involving individuals attempting to manipulate the market by passing false rumors about certain financial institutions. The Commission has investigated trading irregularities and abusive [short-selling](#) practices.

## International Framework

The reports focussed on default prevention, through the reduction of systemic risk, and the handling of an actual default. The reduction of systemic risk can be achieved in several ways. An important step has been to create more transparency in the derivatives market through the introduction of clearinghouses. Another important step has been the design of measures to improve the stability of important financial institutions. With all these new measures, it is important to keep in mind that the risk one tries to reduce can be known, unknown or unknowable.<sup>964</sup> Basel's economic capital and its requirement is based upon known risks only. Starting with the international responses, one of the global responses came from the G20 leaders. It was clear where the G20 thought the responsibility for the crisis lies: major failures of regulation and supervision, plus reckless and irresponsible risk taking by banks and other financial institutions, created dangerous financial fragilities that contributed to the current crisis.<sup>965</sup>

## Responses from the Senior Supervisors Group

The Senior Supervisors Group published a report in March 2008 on the events of 2007,<sup>966</sup> which was followed by a second report in October 2009 as a consequence of the continuing and deepening of the crisis.<sup>967</sup> The Senior Supervisors Group, which is composed of the regulators of Canada, France, Germany, Japan, Switzerland, the UK and the US, combines the opinion and expertise of some of the most powerful and most experienced financial supervisors worldwide. Their report examines how different banks were responding to the

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"Naked-Shorts Ban Gets Chilly Reception". Ellis, David (September 17, 2008). "[Regulator enacts new ruling banning 'naked' short selling on all public companies.](#)". CNN.

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Richard J Herring, 'The Known, the Unknown, and the Unknowable in Financial Policy: An Application to the Subprime Crisis' (2009) 26 Yale J on Reg 391

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G20 Leaders, 'Leaders' Statement: The Pittsburgh Summit' (24-25 September 2009) <[https://g20.org/wp-content/uploads/2014/12/Pittsburgh\\_Declaration\\_0.pdf](https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf)> accessed 14 November 2015

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Senior Supervisors Group, 'Observations on Risk Management Practices during the Market Turbulence' (6 March 2008) <<https://www.sec.gov/news/press/2008/report030608.pdf>> accessed 14 November 2015

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financial crisis and what distinguishes those that are successful from those that are not. The Group identifies four key areas in which risk management practices made a difference to a bank's performance.<sup>968</sup> First, the successful banks had an effective risk management system in place that could share valuable information throughout every level of the organisation, including the board and the Chief Risk Officer. Second, firms that had rigorous and independent valuation practices were better prepared to revalue and write down the complex credit structures that they had on their books. Third, the banks that did well had aligned their capital management, liquidity management and balance sheet management, thereby controlling their balance sheet rather than providing incentives to balloon it. Fourth, banks that did well had much better risk information systems, allowing management to assess their risk positions and change underlying assumptions. Better systems were able to integrate their market risk, i.e. the risk of changing share prices, interest rates and exchange rates, with their counterparty risk, i.e. the risk of default of the counterparty. Engagement of senior management played an important role in how the bank fared so far. Banks where senior management was able to implement its balance between risk appetite and its desire to do business, where it could identify, understand and act upon risks and where there was a good flow of information throughout the structure aided by cross-disciplinary communication. The second report by the Senior Supervisors Group<sup>969</sup> adds to this by adding ten areas of continued improvement.

## The Basel Committee

The Basel Committee wrote the leading Basel II report, which advocated the structure of three pillars: minimum capital requirements, supervisory review process and market discipline. In the aftermath of the crisis, the Committee drew up a program of reform of the banking sector addressing the issues raised by the G20. The Committee describes the objective for reform following the crisis as to better protect consumers, depositors and investors.<sup>970</sup> In its report to the G20 the Committee outlined elements to improve the resilience of the banks and the global banking system. On a firm-level, the committee looked at capital, liquidity, risk management and market discipline. This approach corresponds with the three pillar approach of Basel II. Several improvements to capital were suggested. Firstly, the definition of tier 1 and tier 2 capital, which represents the different quality levels of capital that a bank can hold, was improved. A greater emphasis was placed

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<sup>968</sup>

Senior Supervisors Group (n 13) 3

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Senior Supervisors Group (n 1)

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Basel Committee on Banking Supervision (n 3)

on common equity, which is regarded as the highest quality of capital. Secondly, the risk that this capital needs to cover was extended to include those risks that were not covered previously. This resulted in several reports, such as the report on sound compensation practice<sup>971</sup> and the report on enhancing corporate governance of banks.<sup>972</sup> The points represent a recurring theme throughout most of the reports that were written by other organisations. In relation to the third of the three pillars, market discipline, the Committee concluded that the disclosure provided by the banks, both of the risk and of the capital base, was inadequate. An increased disclosure of remuneration practice has been proposed. On a macro-level, the two concerns raised by the committee are procyclicality, or the increase in risk as the economy grows, and systemic risk, or the risk arising from interconnectedness of markets and its participants. The capital ratios will be strengthened during a good period to provide a buffer during bad years. A countercyclical capital buffer is introduced for this purpose.<sup>973</sup> To reduce systemic risk, the Committee proposed an overhaul of the over-the-counter derivative markets, extra capital requirements for inter-financial exposure and limitations to overreliance on short-term interbank funding. Dealing with the default of a bank remains a difficult problem. One suggestion is to have contingent capital, which allows capital instruments to be written off or converted to common shares.<sup>974</sup>

## Critique on the Basel Reports

Basel I had its shortcomings, partly for political reasons in that it represented the most that the parties involved could agree at the time. It is worth highlighting some of its major deficiencies so that the progress and changes of Basel II can be better understood. It may be argued that Basel I had made the financial system less stable, not more.<sup>975</sup> That conclusion is reached on the basis of several shortcomings. There is the arbitrary categorization and weighting of risk which is a far cry from the real world. In order to gain higher returns on their capital, banks started to take larger risks without having to increase their capital. There were also problems with all loans within certain categories, eg, residential lending for property all receiving the same risk weighting. It is claimed that Basel I led to an increase in lending to Asian banks as the capital required for interbank loans with a maturity less than a year is far less than that required for lending to non-banks. At 1997 over 60% of all

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Basel Committee on Banking Supervision, 'Pillar 3 Disclosure Requirements for Remuneration' (July 2011) <<http://www.bis.org/publ/bcbs197.pdf>>

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Basel Committee on Banking Supervision, 'Principles for Enhancing Corporate Governance' (October 2010) <<http://www.bis.org/publ/bcbs176.pdf>>

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Basel Committee on Banking Supervision (n 3) 9

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Ibid 10

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L. Jacobo Rodriguez, 'Banking Stability and the Basel Capital Standards' (2003) 23 Cato J 115, 119

international bank lending to Asia had a maturity of less than a year; this has contributed to the Asian crisis, surely the opposite of what Basel I had set out to achieve. Others are more positive about Basel I, claiming that it has achieved its objectives of improving stability whilst providing a level playing field amongst banks, despite its simplicity.<sup>976</sup>

Basel II sought to address some of the issues of Basel I by allowing the banks to use their sophisticated internal methodologies to measure the risk of their assets and portfolios. Since the development of Basel I, large banks have invested resources into developing better ways of assessing their risk. Their systems were more sophisticated than the crude methods of Basel I and Basel II sought to use these improved techniques. It would allow a better link between risks, capital required and reward as return on capital. This raises two questions. What would stop banks from gaming this system by designing their internal methodology in way favorable to them and will this give an unfair disadvantage to smaller banks that do not have the capability or resources to invest in their methodology?<sup>977</sup> In the US, the scope of application of Basel II has been reduced to the large banks. They have a greater need for a sophisticated way to measure their risks due to the scale of their operations. The smaller US banks, which are the majority of the US banks, are considered to be capitalized according to Basel I standards.<sup>978</sup>

The coming into force of Basel II had significant consequences for areas of banking, including project finance. Unless the bank would qualify to use the internal rating-based approach, the loans would attract a weight beyond the 100% set by Basel I. Apart from qualifying for using an internal methodology, banks had other options: to use securitization, to use monoline insurance, or to merge with competitors.<sup>979</sup>

The Basel III report is an important report produced in the wake of the crisis. Although that statement holds true from a regulatory perspective and it may present the banks with a great amount of work in the coming years to implement it in full. If one regards corporate governance as a system by which companies are controlled.<sup>980</sup> The proposals will have an impact on shareholders as the amount of capital that is required to undertake the same banking activities will be higher. Basel III consists of the framework to manage liquidity

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Roger W. Ferguson Jr, 'Capital Standards for Banks: The Evolving Basel Accord' (2003) 89 Fed Res Bull 395, 396

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L. Jacobo Rodriguez (n 109) 121

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Roger W. Ferguson Jr (n 111) 400

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Nick Bliss and Victoria Harud, 'The Mother of Invention' (2007) 26 Int'l Fin Rev 38

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Sir Adrian Cadbury, Report on the Committee on the Financial Aspects of Corporate Governance (London, Gee&Co, 1992)  
<<http://www.icaew.com/~media/corporate/files/library/subjects/corporate%20governance/financial%20aspects%20of%20corporate%20governance.ashx>> accessed 14 November 2015, at paragraph 2.5

risk<sup>981</sup> and the second to outline a global regulatory framework.<sup>982</sup> Many of the proposals contain implementations of the response made to the G20.<sup>983</sup> The emphasis is on strengthening capital and liquidity requirements to improve the resilience in the banking sector. Basel III requires banks to improve the quality of capital; in particular tier 1 capital, the highest quality of capital, and to increase the risk that capital needs to cover and to increase the capital requirement ratio itself. Increasing capital ratios includes increasing the level tier 1 capital hold against risk weighted assets (“RWAs”) to 4.5% and the building up of both a conservation buffer and a countercyclical buffer. To protect liquidity, something that proved disastrous during the crisis, two new ratios are introduced: the liquidity coverage ratio and the net stable funding ratio. A timeline has been drawn up for the introduction of these new ratios. All these combined individual measures show an underlying trend towards a much stronger and more integrated form of risk management. The bringing together of the different parts of the organisation is crucial in forming this integrated risk management. Compared with Basel II, the conclusion can be that the level of risk management that is required is raised. The integration of a stronger risk management into the system by which companies are controlled can be identified as a unifying objective of all the measures outlined in Basel III and as its biggest influence on corporate governance of banks. This should not be surprising, as risk management is seen as such an element of corporate governance for banks.<sup>984</sup> Risk management is an element of corporate governance for any company is acknowledged through the UK Corporate Governance Code<sup>985</sup> and by the Financial Reporting Council.<sup>986</sup>

## Corporate Governance of Banks

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Basel Committee on Banking Supervision, ‘Basel III: International Framework for Liquidity Risk Management, Standards and Monitoring’ (Dec 2011) <<http://www.bis.org/publ/bcbs188.pdf>>

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Basel Committee on Banking Supervision, ‘Basel III: A Global Regulatory Framework for More Resilient Banks and Banking System’ (June 2011) <<http://www.bis.org/publ/bcbs189.pdf>>

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ibid

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Gottfried Wohlmannstetter, ‘Corporate Governance von Banken’, in Klaus J Hopt and Gottfried Wohlmannstetter (eds), *Handbuch Corporate Governance von Banken* (Verlag 2011) 67-69

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Financial Reporting Council, ‘Internal Control: Revised Guidance for Directors on the Combined Code’ (2005) <<https://www.frc.org.uk/getattachment/5e4d12e4-a94f-4186-9d6f19e17aeb5351/Turnbull-guidance-October-2005.aspx>>

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Financial Reporting Council, ‘Boards and Risk: a Summary of Discussions with Companies, Investors and Advisers’ (2011) <<https://www.frc.org.uk/FRC-Documents/FRC/Boards-and-Risk-A-Summary-of-Discussions-with-Comp.aspx>>

The Committee has published reports on corporate governance of banks in 1999<sup>987</sup> and in 2006.<sup>988</sup> Both reports appeared after the OECD had published their updated reports on corporate governance, in 1999<sup>989</sup> and 2004.<sup>990</sup> Following the crisis, and taking into account various other reports that have been published since, including those by the Senior Supervisors Group on risk management during<sup>991</sup> and after the crisis,<sup>992</sup> and by the OECD,<sup>993</sup> the committee has updated its report on corporate governance of banks in 2010<sup>994</sup> and in 2015.<sup>995</sup> The October 2010 version is relevant as it contains the responses to the financial crisis. Given the importance of the committee, this report is an aid in answering the research questions. Among some of the failures of corporate governance of banks, the Committee mentions explicitly and upfront insufficient board oversight of senior management, inadequate risk management and complex organisational structures and activities.<sup>996</sup> The committee identifies fourteen principles that represent elements of an effective corporate governance development process for banks. These principles address the areas listed above where the Committee believes the focus for improvement should be. In the version of July 2015, the eleven principles are reworded but remain in essence much the same. The Committee is the influential organisation worldwide shaping financial regulation, it is worth

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The Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations' (September 1999) <<http://www.bis.org/publ/bcbs56.pdf>>

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The Basel Committee on Banking Supervision, 'Enhancing Corporate Governance for Banking Organisations' (February 2006) <<http://www.bis.org/publ/bcbs122.pdf>>

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OECD, 'OECD Principles on Corporate Governance' (April 1999) <[http://www.ecgi.org/codes/code.php?code\\_id=89](http://www.ecgi.org/codes/code.php?code_id=89)>

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OECD, 'OECD Principles on Corporate Governance' (April 2004) <<http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf>>

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Senior Supervisors Group (n 13)

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Senior Supervisors Group (n 1)

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OECD, 'Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles' (February 2010) <<http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/44679170.pdf>>

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The Basel Committee on Banking Supervision (n 26)

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Basel Committee on Banking Supervision, 'Guidelines: Corporate Governance Principles for Banks' (July 2015) <<http://www.bis.org/bcbs/publ/d328.pdf>>

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The Basel Committee on Banking Supervision (n 26) 2

going through each of the fourteen principles: they are likely to shape the debate on corporate governance of banks for the coming years. Rather than discussing each principle in turn they are discussed where they are placed in the context of the weaknesses they seek to address. Some of them relate to board effectiveness, whilst others relate to culture and remuneration. Each principle is matched to the corresponding weaknesses in corporate governance at UK banks. The July 2015 version of the principles of corporate governance adds a new principle, Principle 13 in its new system, which includes the role of supervisors in corporate governance at banks. Supervisors should provide guidance for and supervise corporate governance at banks, should require improvement and remedial action, and should share information on corporate governance with other supervisors.<sup>997</sup> Although the board and senior management are responsible for the governance of the bank, the supervisors should assess their performance in this context. Some include that supervisors should evaluate whether the board and senior management have processes in place for the oversight of the bank's strategic objectives, including risk appetite, financial performance, capital adequacy, capital planning, liquidity, risk profile and risk culture, controls, compensation practices, and the selection and evaluation of management. This expands the role of the supervisor. Under these guidelines, the supervisor becomes responsible for supervising the internal processes at the bank and areas such as culture and compensation. The supervisor should get increased powers over the composition of the board and senior management: supervisors should evaluate the processes and criteria used by banks in the selection of board members and senior management and obtain information about the expertise and character of board members and senior management.

## **Changing the Culture**

One of the weaknesses in corporate governance at UK banks is the culture within the banks. There is an emphasis on growth and profit over risk management and the interests of external stakeholders. This is evidenced by a large number of scandals, such as the LIBOR manipulation and the PPI mis-selling, and the problems at Barclays and the Co-operative Bank. This section contains an overview of the recommendations made to address these and

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of the measures taken. These include restrictions on remuneration; increase in competition; restructuring the financial regulator to increase focus on conduct; and measures to address the manipulation of benchmarks such as LIBOR. The Basel Committee defined various principles of good corporate governance. Two are related to culture as they seek to provide guidance on the remuneration practices and their alignment with the bank's risk appetite. Principle 10: The board should oversee the compensation system's design and operation, and should monitor and review the compensation system to ensure that it operates as intended.<sup>998</sup> Principle 11: An employee's compensation should be aligned with prudent risk taking; compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

The Senior Supervisors Group named remuneration as an example of an area where the risk appetite of an organisation determined by the board was ignored in practice.<sup>999</sup> Remuneration in banks is an area of much controversy attention. In a separate report, the commission argues for more transparency and disclosure on remuneration practices.<sup>1000</sup> It can be traced back to principles of fairness and integrity within an organisation as outlined by Cadbury. The point is that bringing in staff from another organisation with the agreement of a large guaranteed bonus may not only be contrary the risk appetite of the organisation, it may cause grievance with existing members of staff. The FSA had made an effort to improve the connection between risk and rewards. It had done so via its handbook by way of SYSC 19. The aim was to try and make the remuneration risk neutral. This part of the handbook has been updated following the implementation of EU legislation.<sup>1001</sup> The UK government in fact resisted the EU regulation on bankers' remuneration: it sought to challenge it through the court only to abandon it when the adviser to the European Court of Justice rejected its arguments.<sup>1002</sup>

## Independent Commission on Banking

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Basel Committee on Banking Supervision (n 45) 25

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Senior Supervisors Group (n 1) 24

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Basel Committee on Banking Supervision, 'Pillar 3 Disclosure Requirements for Remuneration' (July 2011) <<http://www.bis.org/publ/bcbs197.pdf>>

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Financial Conduct Authority 'IFPRU Remuneration Code (SYSC 19A)' (2016) <<https://www.thefca.org.uk/firms/remuneration/ifpru-remuneration-code-sysc-19a>>

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BBC, 'Osborne abandons challenge to EU cap on bankers' bonuses' (20 Nov 2014) <<http://www.bbc.co.uk/news/business-30125780>>



The Independent Commission on Banking, which was established by the UK government in June 2010 and was chaired by Sir John Vickers, wrote a report to consider structural and related non-structural reforms to the UK banking sector to promote financial stability and competition.<sup>1003</sup> The recommendations have three aims to reduce the probability and impact of systemic financial crises in the future; to maintain the efficient flow of credit to the real economy; and to preserve the functioning of the payment system and guaranteed capital certainty for small savers and small businesses. The report is divided in two parts: the first part concerns financial stability whilst the second part concerns competition.

## **Benchmarks**

In the wake of the LIBOR scandals, the Financial Services Act 2012 contains provisions on misleading statements, misleading provisions and misleading statements in relation to benchmarks. Traders who deceived their rate setting colleagues by amending their own prices of assets would fall under section 91(2). A person (“C”) who does any act or engages of conduct which creates a false or misleading impression as to the price or value of any investment or as to the interest rate appropriate to any transaction commits an offence if—

- (a) C intends to create the impression,
- (b) the impression may affect the setting of a benchmark,
- (c) C knows that the impression is false or misleading or is reckless as to whether it is, and
- (d) C knows that the impression may affect the setting of a relevant benchmark.

It is note that section 91(3) provides a justification for such actions as it may occur in a financial crisis. In proceedings for an offence under subsection (1), it is a defence for the person charged (“D”) to show that the statement was made in conformity with—

- (a) price stabilising rules,
- (b) control of information rules, or
- (c) the provisions of Commission Regulation (EC) No 2273/2003 of 22 December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards exemptions for buy-back programmes and stabilisation of financial instruments.

The purpose of these provisions is to give the regulators the most convenient tools for these situations and an attempt to clean up and re-establish public trust in the banking sector.

## **Increasing Board Effectiveness**

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In RBS and Barclays, the board could not challenge a dominant CEO sufficiently. The rapid expansion at Northern Rock and at HBoS was not challenged by the board. The boards lacked experience in banking and could not provide adequate oversight and challenge. It allowed a culture to be established within the banks placing growth and profit before anything else. The case study of the Coöperatieve Bank provided a persuasive argument for increasing board effectiveness. This section sets out the most important responses and measures taken to address these weaknesses. The principles on corporate governance set out by the Basel Committee relate to board effectiveness. It starts with the principle, which is an overriding objective of what the board's responsibility is principle 1: The board has responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values.

This goes back to Cadbury who states that the boards of directors are responsible for the governance of their companies. The risk management function has been highlighted as important. The oversight of senior management is presumably as a consequence of the failure of board members to challenge senior executives at several banks. Principle 2: board members should be qualified, including through training, for their positions. They should have an understanding of their role in corporate governance and be able to exercise sound and objective judgement about the affairs of the bank. Directors should be knowledgeable on banking and finance: commercial skills and experience may be sufficient in other organisations, but banks require specialist knowledge. This conclusion has been drawn by lessons from failed banks. The Senior Supervisors Group noted that boards are trying to expand their knowledge base and financial expertise as a response to the crisis. Principle 3: the board should define governance practices for its own work and have in place the means to ensure that such practices are followed and reviewed for improvement. Principle 4: in a group structure, the board of the parent company has the responsibility for adequate corporate governance across the group and ensuring that there are governance policies and mechanisms appropriate to the structure, business and risk of the group and its entities.

Integrity and accountability are aided by the internal information and control systems as set out in the Turnbull Guidance and by the IMF and OECD. The quality and the integrity of the information are crucial for transparency and accountability. Principle 5: under the direction of the board, senior management should ensure that the bank's activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board. The Senior Supervisors Group expressed its dissatisfaction with the lack of consistency between the risk appetite defined by the board and that implemented at lower levels. The board may agree on a risk appetite and strategy may be one thing, but overseeing that this is implemented and adhered to throughout the bank is a different matter. It requires clear lines of communication and information both from the board into the business but also the other way; this is outlined in the next principles. Principle 6: banks should have an effective internal controls system and a risk management function with sufficient authority, stature, independence, resources and access to the board. Principle 7: risks should be identified and monitored on an ongoing firmwide and individual entity basis, and the sophistication of the bank's risk management and internal control infrastructures should keep pace with any changes to the bank's risk profile, and to the external landscape. Principle 8:

effective risk management requires robust internal communication within the bank about risk, both across the organisation and through reporting to the board and senior management. Principle 9: the board and senior management should utilise the work conducted by audit functions, external auditors and internal control functions.

Principles 6, 7, 8 and 9 build upon principles 3 and 4 providing detail on the internal controls and systems. It is emphasised that the information on the bank's risks must be accurate and of high integrity. But these systems need to be flexible so that in a time of rapidly changing markets they can be adapted to the new situation. Keeping these large information structures flexible within a bank is no simple task. As per the first and fourth point noted by the Senior Supervisors Group, banks with a good and adaptable risk management system in place that shared information at every level of the organisation, including the board, found it easier to stay on top of things during the financial crisis. Principle 12: the board and senior management should know and understand the bank's operational structure and the risks that it poses. Principle 13: where a bank operates through special-purpose or structures or in jurisdictions that impede transparency or do not meet banking standards, its board and senior management should understand the purpose, structure and unique risks of these operations. These in essence come back to the principle of transparency and to the educational requirement of the board. Principles 12 and 13 have been dropped in the July 2015 version of the report. It lists the next Principle 14 as the Principle 12. Principle 14: the governance of the bank should be transparent to its shareholders, depositors, other stakeholders and market participants. It is remarkable that only in the last of its fourteen principles the Committee mentions shareholders and stakeholders. It mentions these in the third pillar of Basel II, disclosure. It does not just mention shareholders, but the Committee acknowledges that there is a range of stakeholders, including depositors and other market participants, who need to be involved and informed. It uses an enlarged group of actors in the system of corporate governance, as was done by the OECD<sup>1004</sup> globally and the Winter report<sup>1005</sup> within the EU, and in reports by the Committee.<sup>1006</sup>

The Walker Review noted that some boards were far more effective than others at creating solutions and implementing these at the time of the crisis than others, despite that they had the same obligations to their shareholders.<sup>1007</sup> This difference was noted by the Senior

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OECD, OECD Principles of Corporate Governance (Paris, OECD Publication Service 2004) <<http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf>>

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Jaap Winter, 'Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe' (Brussels, 4 November 2002) 59 <[http://ec.europa.eu/internal\\_market/company/docs/modern/report\\_en.pdf](http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf)>

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Basel Committee on Banking Supervision, Enhancing Corporate Governance for Banking Organisations (Bank for International Settlements, 2006)

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Supervisors Group<sup>1008</sup> and allows for some comparison between good and bad practices. The Walker Review seeks to investigate this difference by answering several questions, notably by questioning whether to extend the statutory responsibility of the board to include depositors or society as a whole and by examining the role of non-executive directors. The review considered extending the responsibilities beyond those to shareholders to include employees, depositors and taxpayers, and the creation of a non-executive director for public interest, it recommends focussing on the accountabilities rather than expanding on these.<sup>1009</sup> The argument presented in support of not expanding the responsibilities is that the Companies Act 2006 s172-174, which describes the duties of the director, is sufficient: damaging public confidence and not meeting obligations to depositors is not the long-term interests of the company. These sections in the Company Act 2006 have been called enlightened shareholder value as it goes somewhat further than plain shareholder value.<sup>1010</sup> Instead of amending the statutes, the review concludes that a great deal can be achieved within this framework. The requirement of specialist knowledge concerning the financial industry for the directors is greater than in other sectors. It requires a specialised set of skills and knowledge as the impact of the lack of it on society is far greater than in other industries. This observation corresponds with principle 2 of the Basel Committee<sup>1011</sup> and observations made by the Senior Supervisors Group on how board members are selected.<sup>1012</sup> It presents the problem of independence of non-executive directors as the best place to build this knowledge is from within the industry itself. This would ask for scrutiny to be placed on the selection process.<sup>1013</sup> But the knowledge and understanding of the financial sector and training is essential for the optimal functioning of each non-executive director. Because of this specialist aspect, the time commitment of a non-executive director will be far greater than in other industry sectors.

The FCA would ensure that the directors are knowledgeable and engaged, which is essential for the proper functioning of the board. The executive needs to be challenged and tested on the proposals that he puts forward. The non-executive directors need to be satisfied that the risk assessment is done properly and that the outcome is in line with the risk strategy.

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Senior Supervisors Group (n 13)

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Sir David Walker (n 4) 34

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Peter Muchlinski, 'Implementing the New UN Corporate Human Rights Framework: Implications for Corporate Law, Governance and Regulation' (2012) 22 Business Ethics Quarterly 147, 160

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The Basel Committee on Banking Supervision (n 26) 10

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Senior Supervisors Group (n 1) 22

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Sir David Walker (n 4) 45

## Shareholders and the Stewardship Code

There are two types of shareholders, distinguished by the time horizon of their investment. Fund managers may hold the stock only for a short period, deciding to sell it if they do not like the direction the company is going. There are the investors who intend to hold on to the stock for a long period of time. This group of investors may seek to influence the decisions of the board if they do not like the direction that the company is going in.

Some fund managers may be hesitant to subscribe to such a code, the least that can be expected in the governance process is that they are involved in the selection of the board and in holding it to account on their performance. The Institutional Shareholders' Committee, renamed the Institutional Investor Committee on the 18<sup>th</sup> of May 2011, published the Code on the Responsibilities of Institutional Investors.<sup>1014</sup> The Code has to enhance the quality of the dialogue of the institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities. The code is made up of seven principles. The investors will need to monitor their investee companies. They need to satisfy that the board and its commissions are effective. They need to maintain an audit trail of the monitoring activities. Investors may escalate their activities if required but should do so in line with guidelines that they have set out themselves. Investors should have a policy on voting and report on their stewardship and voting activities. The Financial Reporting Council is responsible for the UK Corporate Governance Code.<sup>1015</sup> All companies with a Premium Listing in the UK are required under the Listing Rules to report on how they have applied the UK Corporate Governance Code. The Walker Review suggests that it should be placed within the remit of the Financial Reporting Council to design principles of best practice in stewardship by institutional investors and fund managers.<sup>1016</sup>

## Governance of Risk

For any business, the management of financial risk and many other types of risk is important and subject to constraints. For large financial institutions, it is part of their strategic objectives. They take on financial risk and a much higher form of leverage than is in other types of industries. The consequences of these risks are larger in terms of social costs, exceeding the downside risk to shareholders. The board would need to make decisions on whether new complex structures or overseas operations would give sufficient return taking into account the regulatory costs rising from the associated risks. The Senior Supervisors

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Institutional Shareholders' Committee, 'Code on the Responsibilities of Institutional Investors' (16 November 2009) <<http://www.uss.co.uk/Documents/ISC%20Code%20Responsibilities%20of%20Institutional%20Investors.pdf>>

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Financial Reporting Council, 'The UK Corporate Governance Code' (June 2010) <<http://www.frc.org.uk/getattachment/b0832de2-5c94-48c0-b771-ebb249fe1fec/The-UK-Corporate-Governance-Code.aspx>>

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Group<sup>1017</sup> has emphasised that banks with good and flexible risk management systems that reached up to board level were able to deal with the crisis much better; the Basel Committee has included this in, principles 1 and 5 of its report on corporate governance.<sup>1018</sup>

The Review is concerned by how the governance of risk by the board can be made more effective alongside the regulation.<sup>1019</sup> It summarises, that ‘the obligation of the board in respect of risk should be to ensure that risks are identified and assessed; that risks are effectively controlled; that strategy is informed by and aligned with the board’s risk appetite; and that a supportive risk culture is embedded so that all employees are alert to the impact on the whole organisation of their actions and decisions’. This is in line with what the Basel Committee has dictated, in this case in principles 4 to 8.<sup>1020</sup> The new regulation that is being developed should aim to eliminate the risk of a crisis reoccurring, but the Review notes that it must not be the job of the regulator to sit on the board of the banks. The regulators must stand back to allow for new developments, products and inventions whilst satisfying itself in the capabilities and effectiveness of the board to discharge its obligations in relation to the associated risks. Not only is the audit committee loaded with the demanding task of financial reporting and internal control, the task of risk management for a financial institution is so large that it may overload the audit committee. The review recommends establishing a separate board risk committee which should focus on the prudential risks of the institution.<sup>1021</sup> These risks include leverage, liquidity risk and market risks including interest rate and currency risk, credit risk and counterparty risk. The Board Risk Committee, which as any board committee should consist of nonexecutive directors, should be supported by a Chief Risk Officer (CRO). The requirement of a Chief Risk Officer within the bank emphasises a small but important part of principle 6 of the Basel Committee, where this role is mentioned.<sup>1022</sup> The Chief Risk Officer should operate at board level risk governance but be independent of any business unit.<sup>1023</sup> Besides the daily tasks, the Board Risk Committee must be involved in major strategic transactions, such as an acquisition, to ensure that proper

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The Basel Committee on Banking Supervision (n 26)

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Sir David Walker (n 4) 91

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The Basel Committee on Banking Supervision (n 26)

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Sir David Walker (n 4) 94

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The Basel Committee on Banking Supervision (n 26)

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Sir David Walker (n 4) 99

due diligence has been conducted and to assess the consequences of the risk profile of the company after the transaction. It needs to take into account whether it falls within the risk tolerance and appetite as defined in the risk strategy. This is principle 5 as defined by the Basel Committee.<sup>1024</sup> Note that the risk strategy, tolerance and appetite should be included in a risk report, which must form part of the annual report and accounting obligations.<sup>1025</sup>

The literature supports the view that corporate governance for financial institutions is different from that of nonfinancial ones mainly due to the fact that the principal-agent problem is more complex for banks and other financial institutions than it is for non-financial ones. At the other end of the spectrum, there are those who consider that corporate governance should not be different for financial and non-financial companies. The main studies in the field mention more or less the same basic elements distinguishing financial from non-financial firms and those are: opaqueness of bank operations, heavy regulation, and higher moral hazard opportunities by managers.<sup>1026</sup> The literature review showed a lack of consensus among the academia on which performance indicators and which corporate governance indicators are the most adequate ones for testing this relationship. Some studies showed that a higher frequency of board meetings combined with higher director fees and ownership stake and better attendance rates translates to higher profit efficiency of banks. There are studies that find that the lower the proportion of internal directors and an external chairperson will produce higher return on assets and return on equity for the bank. There are some studies that find that the board size and performance as measured by Tobin's Q are positively related. The financial sector in United States has seen thirteen relevant pieces of legislation spanning from 1913 to 2010 which have shaped the behaviour of financial firms. The regulation was intensified after the financial crisis which was blamed on failures of corporate governance practices of banks and other financial institutions. The regulation addressing corporate governance practices such as the Sarbanes-Oxley Act, Basel II, and Core Principles for Effective Banking Supervision are discussed.<sup>1027</sup>

### **Risk management, internal controls and governance**

Banks' lax internal governance and risk management lie at the root of the financial crisis since they are the first level of protection for individual institutions and the system as a whole. They were items of primary concern in the post-crisis agenda. Pillar 2 revision in the enhanced Basel II framework intends to strengthen risk management practices and overcome the loopholes in internal controls and risk models in order to better capture risks in

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1025 The Basel Committee on Banking Supervision (n 26)

1026 Sir David Walker (n 4) 105

This leads to a consensus that financial institutions are different from non-financial ones, thus the corporate governance should be adapted accordingly.

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The common aspect of all these bits of legislation is the increase of disclosure and transparency practices of financial institutions as one of the key aspects of improving corporate governance.

internal assessments of capital adequacy. Under Pillar 2 banks must apply stress testing that will play a leading role in strengthening bank's governance and the resilience of individual banks and financial system. Stress tests should keep banks management alert for potential shocks as a result of market reversal. This way banks have an indication how much capital they would need in order to absorb losses in times of adverse market conditions, i.e. they can plan their capital levels in the long-run so as to be prepared for such conditions and control their solvency risk. Stress tests are intended to supplement the other risk management tools and help overcome the limitations of historical data used in measurement methods and particularly the shortcomings of VaR models. Stress tests will allow a broader view over bank's total risk profile by including a wider range of risk scenarios.

Basel II enhancements require that board and management have an understanding of risk exposures on a firm-wide basis and are duly informed about the capital market activities and products in which their bank is involved. With respect to new products and activities- such as securitization and off-balance sheet activities and complex products- senior management should understand the underlying assumptions in the business models and establish sound and effective valuation and risk management practices in order to assess the fair value of the financial instruments and control the associated risks. A sound and resilient valuation system will allow banks to produce a fair value of their assets at any time even when markets disrupt and there is not a reliable price benchmark anymore. In addition to the strengthened internal controls by the enhancements, in October 2010 BCBS issued Principles for Enhancing Corporate Governance which aim to address main deficiencies in bank corporate governance revealed by the crisis. The Principles recommend that supervisors establish guidance or rules requiring banks to have sound corporate governance strategies, policies and procedures<sup>1028</sup>.

## **Transparency**

The crisis of 2007-2008 was to a large extent a crisis of confidence. The inconsistent and insufficient information disclosure in banking sector before the crisis led to a mutual lack of trust among banks and the related credit crunch in interbank lending as well as to the investors' withdrawal from securities trade and the subsequent market break down. One of the main and most important achievements of the new regulation is the establishment of uniform disclosure rules in order to improve transparency, promote better market discipline and avoid uncertainty in decision making in the future.

## **Financial accounting<sup>1029</sup>**

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<sup>1028</sup>

Basel Committee on Banking Supervision: The Basel Committee's Response to the Financial Crisis: Report to G20, p. 7 October 2010, Basel

<sup>1029</sup>

Basel Committee on Banking Supervision: Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems, p.6, December 2010, Basel



Financial accounting rules created incentives for regulatory arbitrage before the crisis and became a reason for huge financial losses banks with large securitization exposures suffered during the crisis because of the fair value measurement. BCBS in collaboration with the International Accounting Standard Board (IASB) is advocating changes in accounting standards which promote more forward-looking dynamic provisioning based on expected losses approach that recognizes credit losses earlier and is less procyclical than the current incurred loss approach.

### **The UK Stewardship Code**

The Financial Reporting Council (FRC) has issued the UK Stewardship Code which aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities. The UK Corporate Governance Code has emphasised the value of a constructive dialogue between institutional shareholders and companies based on a mutual understanding of objectives.

The principles of the UK Stewardship Code are: principle 1: institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities; principle 2: institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed; principle 3: institutional investors should monitor their investee companies; principle 4: institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value; principle 5: institutional investors should be willing to act collectively with other investors where appropriate; principle 6: institutional investors should have a clear policy on voting and disclosure of voting activity; principle 7: institutional investors should report on their stewardship and voting activities. The Stewardship Code is to be applied on a comply or explain basis. The UK Stewardship Code is addressed in the first instance to firms who manage assets on behalf of institutional shareholders such as pension funds, insurance companies, investment trusts, and other collective vehicles. The FRC encourages all institutional investors to report whether they have complied with the Stewardship Code. Monitoring and review of the application of the Stewardship Code will be in two phases. As an interim measure, the Investment Management Association (IMA), will carry out its regular engagement survey which will cover adherence to the Stewardship Code in 2010. The FRC points out that there are a number of significant issues which were raised during the consultation phase which are not addressed in the UK Stewardship Code. These include disclosure by institutional investors of their policies in relation to stock lending; arrangements for voting pooled funds; and the information to be disclosed in relation to voting records. The FRC will undertake additional work in relation to these areas prior to the monitoring exercise in 2011. A EU Green Paper 'Corporate governance in financial institutions and remuneration policies' may have ramifications for the UK Stewardship Code as in section 5.5, the Green Paper mentions that the Commission intends to carry out a review centred around institutional investors

adherence to stewardship codes of best practice. It is apposite to conclude with a comment from [Bob Campion in his article ‘Managers on alert to comply or explain’](#). The new code is a timely opportunity for pension trustees to get to grips with their role as institutional shareholders. If they do, it will be up to fund managers to demonstrate their own expertise in this area or risk losing business.<sup>1030</sup>

In 2002 the ISC issued guidance on shareholders activism which indicated that an institutional shareholder should monitor the performance of their investee companies through regular dialogue where appropriate, intervene where necessary, as well as evaluate the impact of their activism and report to their beneficial owners. The ISC transformed these guidelines into its code: the Code on Responsibilities of Institutional Investors 2009. Myners Report (2001) proposed that a duty should be imposed on the UK based pension funds like their US counterparts owe. The Myners’ proposal endorsed through legislative reforms that enable the Secretary of State and the Treasury to make regulations for institutional investors and to require them to disclose information regarding the exercise of their voting-rights.<sup>1031</sup> The financial and corporate crisis (2007-09) led to the commission of the Walker Review (2009) that examined the issues of corporate governance in the UK banks and other financial industry entities. The Review pointed out that the perfunctory behaviour of institutional investors in performing their expected role in corporate governance is one of the reasons of corporate failure. The Walker Review emphasised the role of institutional investors and proposed stewardship obligations for institutional investors and their fund managers in the British model of corporate governance. The Review recommended the conversion of the ISC principle into the Stewardship code that will operate on the basis of the comply or explain model.

The FRC having oversight of the review process to ensure its purposed operation will sponsor and maintain the Stewardship Code. The proposed recommendations are included in the Stewardship Code by incorporating the guidance given to the institutional investors previously contained in section 2 of the Combined Code (i.e. E. Institutional Shareholders). This development led to the Code on Corporate Governance (2010), comprises on section 1, rather than Combined Code, and the UK Stewardship Code (2010). In reply of Walker’s recommendations, the FRC formulated the following policy objectives to judge a Stewardship Code<sup>1032</sup>: the Code should set standards of stewardship to which mainstream institutional investors should aspire, and maintain the credibility and quality of these standards through independent input on the content and monitoring of the Code; the Code should promote a sense of ownership of the Code amongst institutional investors in order to

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<sup>1030</sup>

<http://corporategovernanceoup.wordpress.com/2010/07/06/the-uk-stewardship-code/>

<sup>1031</sup>

The Companies Act 2006, s. 1277 to 1280

<sup>1032</sup>

Financial Reporting Council, Consultation on a Stewardship Code for Institutional Investors, London, (FRC 2010) at page 5

encourage UK and foreign shareholders to apply and report against it; the Code should ensure that engagement is closely linked to the investment process within the investment firm and the Code should contribute towards improved communication between shareholders and the boards of the companies in which they invest; and the Code should secure sufficient disclosure to enable institutional shareholders' prospective clients to assess how those managers are acting in relation to the Code so that this can be taken into account when awarding and monitoring fund management mandates.

The focus of the Stewardship Code is on the UK-based institutional investors and their fund-managers. The code requires that institutional investors should publicly disclose their monitoring policy.<sup>1033</sup> For instance, how they will monitor their investee companies through an active dialogue; what will be their strategy on intervention, policy on responsible use of voting-rights and on evaluation of the reasons given by their investee companies in relation to depart from Corporate Governance Code. They should have a robust policy on managing conflicts of interest by acting in the interests of all clients or beneficiaries at the time of meaningful engagement and responsible use of their voting rights. The institutional investors' monitoring requires them to determine when it is necessary to enter into an active dialogue with the board of their investee companies.<sup>1034</sup> This monitoring process should be regular, clearly communicable, and examined periodically for its effectiveness. The compliance with the terms of their investment mandate should ensure active monitoring through their meaningful engagement with investee companies. The institutional shareholders are free to decide whether or not to engage but their choice should be a considered one based on their investment approach. Their managers or agents are responsible for ensuring that they comply with the terms of the mandate as agreed.<sup>1035</sup> The fund managers' regular contact and their engagement with investee companies have an impact on the quality and quantity of corporate monitoring. The disclosure statements made by institutions under the Stewardship Code should assist their investee companies to understand the approach and expectations of their major investors. These statements should assist those issuing mandates to institutional investment managers to make a better-informed choice for improving the functioning of the market and facilitating the exercise of responsibility to end-investors.<sup>1036</sup>

The Walker report focused on the behaviour of institutional shareholders and recommended that they should be less passive and prepare to engage earlier if they suspect weaknesses in a

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The UK Stewardship Code (FRC 2010), Principle 1

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The UK Stewardship Code (FRC 2010), Principle 3

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The UK Stewardship Code (FRC 2010), Preface at p. 1

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The UK Stewardship Code (FRC 2010), Preface at p. 1

companies' governance. The Walker report examined the role of institutional shareholders in corporate governance in the light of the UK banking industry and its failure rather than considering the issues of financial investment, role of investment intermediaries and weaknesses of corporate monitoring in the existing security investment structure. The investment management industry recognised the monitoring role of fund-managers and the need to ensure that better outcomes resulted from the engagement process, and that this required changes in behaviour from both companies and assets managers'.<sup>1037</sup> The better outcomes relating to fund-managers' monitoring responsibility could be achieved through their strong commitment to the notion of company stewardship to achieve better governance outcomes, recognising the need of their responsible engagement and having a belief in the engagement benefits. The institutional investors' stewardship responsibility require them to maintain a clear audit trail e.g. their private meetings with boards and voting records, and to attend the companies' AGM, where appropriate and practicable. Their monitoring responsibility not only requires them to consider carefully explanations provided by the board of their investee companies against departure from the UK Corporate Governance Code but also to make reasoned judgement in each case and give a written explanation to the companies and enter into dialogue if they do not accept the company position.<sup>1038</sup>

The monitoring responsibility requires that shareholders and their investment managers should actively intervene in relation to their concerns about the company's strategy and performance, and assess the outcome of doing so. The collaborative engagement may be a most effective manner of institutional investors' engagement at the time of significant corporate or economic stress that pose a threat to the ability of the company to continue.<sup>1039</sup> The institutional investors should have a clear policy on voting and disclosure of voting activity.<sup>1040</sup> In case of an unsatisfactory outcome of active engagement, they are required to register an abstention or vote against the resolution proposed by the board but in both cases the company should be informed in advance with reasons. The institutional investors should have to report on their stewardship and voting activities, to their clients or beneficiaries relating to details of how they have discharged their responsibilities.<sup>1041</sup> The operation of the Stewardship Code is voluntary on the bases of the comply or explain approach in which the institutional investors are required to comply with the principles of the code for the monitoring of their investee companies or in case of departure from the code, they are

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The IMA Annual Survey, "Asset Management in the UK 2009-2010" IMA, London, (2010) at p. 75

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The UK Stewardship Code (FRC 2010), Principle 3

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The UK Stewardship Code (FRC 2010), Principle 5

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The UK Stewardship Code (FRC 2010), Principle 6

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The UK Stewardship Code (FRC 2010), Principle 7

required to provide meaningful reasons of non-compliance. The FRC will keep oversight on the operation of the Stewardship Code. Stewardship is a collective responsibility of investors and directors.<sup>1042</sup> & <sup>1043</sup> Their first responsibility is to provide a clear mandate that should cover corporate purpose, value, strategy, relationships, roles and responsibilities. Secondly, they should focus on corporate performance, risks and opportunities, and planting for the future by ensuring that the right investment are being made in innovation, plant, reputation and talent.<sup>1044</sup>

The operation of the Stewardship Code is self-regulatory on the basis of the comply or explain principle like the ISC Code that required a voluntary commitment to the institutional investors to disclose the operation of the Code's principle on their website in the same manner as the FRC drafted the Code of Stewardship. There are many concerns behind the operation of the Stewardship Code 2010 in the achieving of the objectives of responsible corporate monitoring:

First, the operation of the comply or explain principle as a requirement of listing rules is not encouraging in case of the Combined Code where institutional investors, who have a large stake, have failed to evaluate the veracity of the appliance statement and the reasons of the explanatory statements in case of non-compliance.<sup>1045</sup>

Secondly, in the absence of a monitoring authority what is the difference between the ISC Code and the Stewardship Code 2010?

Thirdly, the institutional investors' insufficient expertise, conflict of interest, agent apathy, and collective actions are real problems and without their solutions, it would be an unrealistic expectation that they will oppose the board of directors by performing their stewardship commitments. The institutional investors, as custodians of others' funds, do not like to make the board unhappy through intervention and their investment managers only pay attention to trading decisions rather than corporate monitoring as owners.<sup>1046</sup>

Fourthly, the scope of the Stewardship Code is limited to the extent of institutional investors that aims to enhance the quality of engagement between institutional investors and

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<sup>1042</sup>

Mark Goyder and Philip Goldenberg, Cadbury: A Testbed for Stewardship' the Wall Street Journal

<sup>1043</sup>

<http://online.wsj.com/article/SB10001424052748704130904574643993127344938.html>

<sup>1044</sup>

Mark Goyder and Philip Goldenberg, (n.48)

<sup>1045</sup>

Brian R. Cheffins, "The Stewardship Code's Achilles' Heel" (2010) the Modern Law Rev. 73(6) 1004 at p.1013

<sup>1046</sup>

Brian R. Cheffins, (n.53) 1014

companies.<sup>1047</sup> In existing share-ownership fragmentation of the UK based companies, the domestic institutional investors without foreign institutional investors do not have a big enough stake to get companies to listen to them on major corporate issues, a presumption of the Stewardship Code effectiveness arguably harks to a bygone age.<sup>1048</sup>

Fifthly, the adequacy of informational flow to the investors and market for their effective engagement is risky because of any disclosure of price sensitive information to the market.<sup>1049</sup> There is a risk that public disclosure may be beneficial for market competitors including public unlisted companies and private companies which are not under an equivalent obligation to disclose information to the market. The quality of institutional investors' engagement depends upon the pattern of contact between investment house and company such as CEO, finance directors, chairman, NEDs.<sup>1050</sup>

Sixthly, the performance of investment managers are evaluated and rewarded on the basis of the short-term index-relative performance, they concentrate on the delivery of short-term return.<sup>1051</sup>

Seventhly, the institutional investors engage many investment managers to manage the risks they construct their performance-based portfolio that resulted in excessive diversification with an equity portfolio having thousands of stocks.

The Stewardship Code neither addressed these issues nor explained the misguided interpretation of the fiduciary duties of institutional investors and their investment intermediaries. It is argued that the Stewardship Code extends the monitoring responsibility relating to corporate performance and engagement with companies beyond investment managers to major shareholders. Hence, insurance companies, pension funds, investment trusts and unit trusts have no responsibility to address the Stewardship Code on a comply or explain basis in the absence of any regulatory authority like the FSA for supervision of their fund managers.<sup>1052</sup> Simon Wong argued that the FRC passed up an historic opportunity to

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The Stewardship Code 2010, preface at start on page 1

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Brian R. Cheffins, (n.53) 1020

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Michael Mckersie, 'The Stewardship Code and the Pattern Engagement by Institutional Shareholders with Listed Companies' 2010 Capital Markets Law Journal, 5(4) 439-442

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Michael Mckersie, (n.57) 441

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Simon CY Wong, 'Why Stewardship is Proving Elusive for Institutional Investors' July/August 2010, Butterworths Journal of International Banking and Financial Law, pp. 406-411, [North-western Law & Econ Research Paper No. 10-28](http://www.governanceforowners.com/images/_upload/_pdf/22_comment_121_2.pdf) available on [http://www.governanceforowners.com/images/\\_upload/\\_pdf/22\\_comment\\_121\\_2.pdf](http://www.governanceforowners.com/images/_upload/_pdf/22_comment_121_2.pdf)

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strengthen ISC developed code in which institutions possessed widely disparate conceptions of, and commitment to stewardship, which has become the Stewardship Code.<sup>1053</sup> The focus of the Code on managing conflicts rather than dealing with conflicts of interest is a step backwards and so is an acknowledgement of institutional investors' monitoring shortcomings. The aforesaid structural flaws and markets practices suggested that the Stewardship Code, as a whole in exiting framework, would not have much effect in making the institutional investors as active and responsible corporate monitors as well as to encourage self-enforcement of the Code and publication of a compliance report on their websites. After that, we are going to examine the next step in UK Corporate Governance Reform. It appears that the UK corporate governance reform is improved step by step.

## Next step in UK Corporate Governance Reform

On November 29, 2016, Prime Minister Theresa May's government issued a green paper<sup>1054</sup> (the Green Paper) to canvass opinion on proposed reforms to the UK's corporate governance framework. A green paper is a government consultation document that invites feedback from interested parties on legislative proposals. While the content of the Paper provides some guidance as to the government's current thinking on corporate governance reforms, there is no guarantee that any of the proposals put forward will find their way into the regulatory framework. In her introduction to the Green Paper, Theresa May cites a concern that in recent years, the behaviour of a limited few has damaged the reputation of many, and states that big business must earn and keep the trust and confidence of their customers, employees and the wider public<sup>1055</sup>. The Secretary of State for Business, Energy and Industrial Strategy, Greg Clark, hails the UK's corporate governance regime as one of Britain's biggest assets in competing in the global economy<sup>1056</sup>. Citing proposals by members of the business community to update and amend the corporate governance framework, the Secretary of State states the aim of the Green Paper as framing the discussion around possible amendments to the governance regime relating to (i) executive remuneration and incentivisation, (ii) the representation of employees and other stakeholders in company decision-making, and (iii) enhanced governance standards for large private companies.

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Brian R. Cheffins, (n.53) 1016

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Simon C. Y. Wong, 'The UK Stewardship Code: A Missed Opportunity for Higher Standards' published in *Responsible Investors* on 13<sup>th</sup> July 2010, available on [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1640897](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1640897)

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Corporate Governance Reform – Green Paper, November 2016, available at [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/573438/beis-16-56-corporate-governance-reform-green-paper-final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/573438/beis-16-56-corporate-governance-reform-green-paper-final.pdf)

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Green Paper, Introduction from the Prime Minister, p. 2

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Green Paper, Foreword from the Secretary of State, p. 4

Certain of the proposals develop positions advanced by Mrs May in a speech to launch her leadership campaign on June 11, 2016<sup>1057</sup>, and put forward more recently in a report issued by the think tank “High Pay Centre” and authored by the conservative MP Chris Philp<sup>1058</sup>.

Under current legislation, quoted companies<sup>1059</sup> are required to submit a remuneration policy to a binding shareholder vote at least every three years. They are required to prepare an annual remuneration report that reports on remuneration paid or awarded during the preceding financial year and includes a statement describing how the company intends to implement the current remuneration policy in the financial year following the reporting period. The remuneration report is subject to an advisory shareholder vote at the annual general meeting. If the vote to approve the remuneration report is not passed, the company must re-submit the remuneration policy to shareholders for approval at the next general meeting<sup>1060</sup>. Companies that have a premium listing on the London Stock Exchange are subject to the UK Corporate Governance Code (the “Code”)<sup>1061</sup> on a comply or explain basis. The Code contains high-level guidance on the procedure for setting directors’ remuneration and the role of the remuneration committee<sup>1062</sup>. Government research shows that there have been few instances of remuneration policies and reports being rejected by shareholders, though instances of significant minority opposition are comparatively high<sup>1063</sup>.

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Available at <http://www.wlrk.com/docs/TheresaMayJuly11Speech.pdf>

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Restoring Responsible Ownership – Ending the Ownerless Corporation and Controlling Executive Pay, September 2016, available at [http://highpaycentre.org/files/HPC\\_42\\_WEB\\_amend\\_-\\_Restoring\\_Responsible\\_Ownership.pdf](http://highpaycentre.org/files/HPC_42_WEB_amend_-_Restoring_Responsible_Ownership.pdf)

1059

A UK incorporated company whose shares are admitted to the Official List, or are listed on an exchange in any member state of the European Economic Area, or are admitted to dealing on either the New York Stock Exchange or NASDAQ, see section 385 of the Companies Act 2006

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See sections 420, 439 and 439A of the Companies Act 2006

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The UK Corporate Governance Code, April 2016, available at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx>

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Section D of the Code

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BEIS analysis of Manifest data covering UK companies between October 1, 2013 and October 20, 2016, reproduced in the Green Paper at Table 2 (p. 20)



## Shareholder voting rights

Options tabled to enhance shareholder voting rights on executive remuneration include the following:

- making the executive pay package detailed in the remuneration report or elements of it, such as variable pay subject to an annual binding vote. It is unclear under the Green Paper whether such approval would be retrospective or forward-looking. Under the proposal, the measure might be applied either to all quoted companies or alternatively as an escalation mechanism for companies that experience significant minority opposition to a remuneration report;
- imposing more stringent consequences for companies that lose an advisory vote, for example, requiring any such company to obtain 75% approval for its next remuneration policy;
- requiring or encouraging companies to set an upper limit for aggregate pay in their remuneration policy, and requiring any pay in excess of such limit to be approved through a binding shareholder vote;
- requiring the remuneration policy to be put to a binding shareholder vote more frequently than every three years, or giving shareholders discretion to bring this vote forward; and
- amending the Code to include more specific guidelines on companies' engagement with shareholders on remuneration.

The cited government research shows that to date only six companies have failed to obtain approval of an annual remuneration report and there has been only one instance of a remuneration policy being rejected by shareholders. By contrast, 185 companies have experienced significant minority opposition to a remuneration report and significant minority opposition has been recorded in 80 binding shareholder votes on the remuneration policy<sup>1064</sup>. In light of these figures, we suggest that to have a tangible impact on shareholder oversight of remuneration, measures must be triggered by significant minority opposition. Measures that increase the scope or frequency of shareholder majority votes risk failing to address concerns unless coupled with effective measures to increase shareholder engagement.

## Shareholder engagement

A challenge in the area of remuneration oversight is an apparent lack of shareholder engagement – an impression borne out by relatively low shareholder participation in votes on remuneration<sup>1065</sup>. The Green Paper acknowledges that as pay is seldom a large part of a quoted company's costs, shareholders have little incentive to oppose a remuneration package

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<sup>1064</sup>

Ibid.

<sup>1065</sup>

On average, 28% of shareholders of FTSE100 companies do not participate in remuneration votes, 40% in the case of smaller quoted companies – see Green Paper paragraph 1.30

and risk losing a good management team. The Green Paper puts forward the following options:

- mandatory disclosure of fund managers' voting records, and the extent to which they have made use of proxy voting or voting advisory services. It is noted that the UK Stewardship Code<sup>1066</sup>, directed at institutional investors and administered by the Financial Reporting Council, already encourages institutional investors to disclose this information, and that most investors comply with this guidance;
- establishment of a senior shareholder committee to engage with executive remuneration arrangements. The Green Paper concedes that this risk introducing complexity into the existing unitary board structure in the UK and moving closer to a continental model, where oversight functions are structurally separate to executive functions; and
- introduction of measures to increase the engagement of individual and retail shareholders. The Green Paper notes that individual shareholder engagement is hindered by the fact that most retail shareholders hold their shares through nominee structures, and that there is little demand on the part of retail investors to make use of existing rights relating to shareholder votes and pass-back of information by brokers.

The appetite among institutional investors for greater administrative burdens is unlikely to be great, and, as the Green Paper remarks, any increase in burden on major shareholders risks discouraging investment in UK companies.

### **The role of the remuneration committee**

The role and composition of remuneration committees is governed by a number of high-level principles under the Code, which provides guidance as to a minimum number of directors that should sit on it, managing conflicts of interest, its role in determining executive remuneration and performance targets, and its chairman's obligations to maintain contact as required with principal shareholders about remuneration<sup>1067</sup>. However, the Green Paper cites a concern that remuneration committees are not as effective as they could be in overseeing executive pay arrangements, both because in many cases they are not seen to proactively engage with shareholders and employees, and because there is a perception that they are reluctant to take positions that do not align with the executive team's expectations. The government's proposals are the following:

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The UK Stewardship Code, September 2012, available at <https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx>

1067

The Code, Section D

- remuneration committees should be required to consult shareholders and employees in advance of preparing the company's remuneration policy; and
- to enable remuneration committees to more effectively challenge executives, chairs of the remuneration committee should be required to have served for at least 12 months on a remuneration committee before taking up the role. The Code provides in its general guidelines on the effectiveness of corporate leadership that boards and their committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their duties effectively<sup>1068</sup>.

## Transparency in executive remuneration

In her speech on June 11, 2016, Mrs May made waves by advocating the introduction of disclosure of ratios comparing CEO pay to pay in the wider company workforce. This proposal has formed part of discussion around pay reporting in the UK for some time, and publication of such ratios became mandatory for US public companies for financial years beginning on or after January 1, 2017. In the UK, the proposal has been put forward respectively by Pension and Investment Research Consultants Limited (PIRC)<sup>1069</sup> and the Trade Union Share Owners<sup>1070</sup>, and by conservative MP Chris Philp in a recently issued report. The Green Paper acknowledges the value to investors of having access to pay ratios, when they are presented in the context of the company's performance during the relevant year. However, it cautions that there is a risk that the ratios might produce misleading results that could be misconstrued in public discourse.

The Green Paper invites opinion as to whether existing reporting requirements relating to performance targets triggering bonus payments and benefits under incentive plans should be reinforced. Under legislation, such targets must be reported by quoted companies in their annual remuneration reports. However, in the opinion of the board, is commercially sensitive is exempt from this requirement<sup>1071</sup>. There has been considerable pressure from investor associations for companies to provide full disclosure of performance targets, and, where such targets legitimately constitute commercially sensitive information, to commit to make subsequent disclosure<sup>1072</sup>. The Green Paper invites views on either (i) making retrospective disclosure of bonus targets within a specified timeframe a mandatory reporting

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<sup>1068</sup>

Section B.1 of the Code

<sup>1069</sup>

PIRC UK Shareholder Voting Guidelines 2016

<sup>1070</sup>

Trade Union Voting and Engagement Guidelines (March 2013)

<sup>1071</sup>

The Large and Medium-sized Companies and Groups (Accounts and Reports) (Amendment) Regulations 2013, Schedule 8

requirement or, alternatively, (ii) increasing non-legislative pressure to disclose performance targets, whether through institutional shareholder guidelines or strengthening existing Code provisions<sup>1073</sup>. The Green Paper notes that investor associations have increasingly expressed unease with the complexity of existing long-term incentive arrangements<sup>1074</sup>.

The Paper touches on mandatory holding periods for shares awarded under an LTIP. To address concerns raised by investor associations<sup>1075</sup>, the Green Paper suggests extending this period from the current guideline minimum period of three years under the Code to a five-year minimum. It is suggested that this requirement be combined with a requirement for executives to retain shares until they have built up a shareholding equivalent to 2x gross salary, which mirrors a familiar theme in investor and proxy voting guidelines<sup>1076</sup>.

The Green Paper notes that under companies legislation, companies are required to take into account the interests of different stakeholder groups in their corporate decision-making<sup>1077</sup> and must prepare a strategic report detailing the ways in which these obligations have been met<sup>1078</sup>. Citing examples of poor corporate conduct, the government advances the view in the Green Paper that companies may need to do more to reassure the public that they are

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GC100 Directors' Remuneration Reporting Guidance (August 2016) para 2.1

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The Code provides high level guidance only, see Principle D.1 ("Performance related elements should be transparent, stretching and rigorously applied") and Schedule A

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The Investment Association Principles of Remuneration Section C; Institutional Shareholder Services – UK and Ireland Proxy Voting Guidelines: 2016 Benchmark Policy Section 3

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The Investment Association Principles of Remuneration Section C para 2(i)

1076

Institutional Shareholder Services – UK and Ireland Proxy Voting Guidelines: 2016 Benchmark Policy Section 3

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Section 172 of the Companies Act 2006, which provides that directors are under a duty to promote the success of the company, having regard to the interests of certain specified stakeholder groups (including employees).

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Sections 414(A) and 414(C)(1) of the Companies Act 2006. Note that the extent of the disclosure obligations varies depending on the size and legal status of the company in question.

being run with an eye to the interests of the wider stakeholder community. The Green Paper contains proposals to strengthen the voice of employees, suppliers, customers, pension-beneficiaries and other parties with a direct or close interest in the performance of a company. In her speech on June 11, 2016, Theresa May announced plans to introduce consumer and employee representatives on company boards.

The government notes that the different measures proposed are not exclusive, and that it is open to views as to the flexibility that should be granted to companies in relation to implementation. It suggests that, at the most flexible end of the spectrum would be the establishment of a set of high-level expectations, allowing bodies such as the Financial Reporting Council to establish guidelines on how such expectations should be met. Under the regime, the strongest corporate governance and reporting requirements apply to public and/or quoted companies, on the basis that private companies are subject to more close control by their shareholders. However, research indicates that large businesses are increasingly choosing to operate as private companies in the UK, and the Green Paper therefore invites views as to whether large private companies should be subject to more stringent corporate governance and reporting requirements.

With reference to recent practice, the Green Paper invites views on whether reporting requirements imposed on public and listed companies under existing legislation should be applied on the basis of the size of a business rather than its legal status. It invites input on the appropriate level at which a size threshold should be set. In a final sweep-up section, the Green Paper invites views more broadly on the current corporate governance framework in the UK and how it might be improved. The question focuses in particular on the flexibility of the comply or explain system, asking whether the regime strikes the right balance between high standards and low burdens. The government has stressed that it does not favour any one or more of the measures proposed and is canvassing opinion.<sup>1079</sup> In November 2016, the Department for Business, Energy & Industrial Strategy (BEIS) issued a Green Paper on Corporate Governance Reform. The Green Paper states ‘The aim of this Green paper is to consider what changes might be appropriate in the corporate governance regime to help ensure that we have an economy that works for everyone’. It considers three specific areas of corporate governance which might be built on to enhance the UK’s current corporate governance framework. These areas are:

- executive pay;
- strengthening the employee, customer, and supplier voice; and
- corporate governance in the UK’s largest privately-held businesses.

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‘Cleary Gottlieb Explores What’s Next in UK Corporate Governance Reform’, Simon Jay and Melissa Reid, JAN 9, 2017.

There are 14 Green Paper questions with six relating to executive pay, three to strengthening the employee, customer and wider stakeholder voice, and five relating to corporate governance in large, privately-held businesses. The consultation closed on 17<sup>th</sup> February 2017 and responses to the consultation will be made available by BEIS around May 2017. However, the responses will be made available in collated format and the anonymity of individual responses will be retained.

## **Executive remuneration**

In an interesting article by Aime Williams and Madison Marriage ‘Investors back UK drive to curb executive pay levels’<sup>1080</sup> reports that some of the UK’s largest investors have revealed support for government proposals designed to curb high executive pay in the latest pushback against the widening wealth gap between bosses and workers. Turning to the High Pay Centre, an independent non-party think tank focused on pay at the top of the income scale. It is interesting to note that the High Pay Centre joined forces with the Chartered Institute of Personnel and Development (CIPD) to submit a joint response to the Green paper consultation, marking the commencement of a formal relationship between the two bodies, to advocate fairer and more ethical approaches to pay and reward. Their recommendations include:

- All publicly listed companies should be required to publish the ratio between the pay of their CEO and median pay in their organisation.
- All publicly listed companies should be required to have at least one employee representative on their remuneration committee.
- All publicly listed companies should be required to establish a standalone human capital development sub-committee chaired by the HR director with the same standing as all board sub-committees.
- The Government should set voluntary human capital reporting standards to encourage all publicly listed organisations to provide better information on how they invest in, lead, and manage their workforce for the long-term.

## **Conclusion**

Chapter 4 discusses the crises and regulation, the relative importance of internal and external governance controls, the role of financial regulation, the corporate governance regulation, the responsibilities of the board, reform monetary policy, the duties of directors, regulatory regime, incentive structures and legislative response and passage. The examination follows with U.S. Securities and Exchange Commission, the Basel Committee, Independent Commission on banking, increasing board effectiveness, shareholder and the Stewardships code, governance of risk, risk management, internal controls and governance and the next step in UK Corporate Governance Reform such as shareholder voting rights. It also explores

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corporate governance and excessive regulation, shareholder engagement and the role of the remuneration committee. It is enlightening to go through the regulation in order to avoid repeating the same mistakes. To conclude, this chapter stated corporate law, soft law codes, and financial regulations have been relevant in dealing with corporate governance deficiencies especially with regards to excessive risk-taking and risk and rewards (remuneration) matters.

Having covered the key areas of research the final stage is to consider the conclusions and recommendations.

## Chapter 5

### Conclusions

#### Introduction

This chapter will conclude the thesis, by summarizing the most important points of the discussion and highlighting the balance between risk, growth and profit in the modern corporate governance. It is essential to assess the impact of regulations and litigation of corporate governance and re-define the modus operandi of changing the culture of financial regulations through a changed corporate governance approach. Moreover, it also examines the recommendations for corporate governance and explore the future developments.

#### Recommendations for Internal Corporate Governance

##### Balance between Risk, Growth and Profit

This research covered UK banks which failed during the financial crisis. One of the observations was that the risk appetite and culture within these banks was inappropriate with an emphasis on growth and profit only. Northern Rock failed were that its business model was based on underestimating risks, liquidity risk, and a high risk-reward strategy. The aggressive and high-growth-strategy was based on retrieving funding from the wholesale markets using securities mortgages as collateral, as opposed to the more conservative and traditional approach.

The board and its risk committee at Northern Rock had approved the funding strategy. This strategy was described from anything between inadequate to reckless in several reviews.<sup>1081</sup> The board had reached the wrong conclusion on its strategy and had done so without a backup plan. The fact that the board set out a course that was the wrong one is in itself not so problematic provided it understood and took reasonable business risks: every organisation takes risks. The point is that the reviews show that the risks taken were high, certainly considering the nature of the business Northern Rock was engaged in. Its business was

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Treasury Select Committee, 'Fifth Report of Session 2007-2008, The Run on the Rock' (2008) <<http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>>; Financial Services Authority, 'The Supervision of Northern Rock: a Lesson Learned Reviewed' (2008) <[http://www.fsa.gov.uk/pubs/other/nr\\_report.pdf](http://www.fsa.gov.uk/pubs/other/nr_report.pdf)>



consumer banking, which means it should have defined its risk appetite accordingly. An example of risk appetite was the take-over of ABN Amro by the RBS-led consortium. It was the wrong price, the wrong way to pay, at the wrong time and the wrong deal.<sup>1082</sup> The transaction was completed when the financial crisis had taken the markets in its grip. The transaction was financed by short term funding and was based on limited due diligence. The case study of HBoS demonstrated that this caused an increase in complexity of the business model, which led to its collapse. HBoS mentioned the case of Peter Cumming – only person found guilty following the crisis. The case study of Barclays showed that an increased pursuit of profit and growth, personified by its CEO, Bob Diamond, led to a culture where moral and ethics were absent. It can be concluded that there was a culture at board level within most of the UK banks to engage in strategies carrying a high risk in pursuit of growth and profit. Going back to the principles set out by the Basel Committee, it is clear that this course of action by the board and senior management, at the banks was contrary to the following principles: ‘Principle 1: The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank’s strategic objectives, risk strategy, corporate governance and corporate values. The board is responsible for providing oversight of senior management’.<sup>1083</sup> ‘Principle 5: Under the direction of the board, senior management should ensure that the bank’s activities are consistent with the business strategy, risk tolerance/appetite and policies approved by the board’.

Setting out the risk strategy is a responsibility of the board and must be done in harmony with its strategic objectives. The board would need to define a risk policy framework. Within such a framework, important strategic decisions, including a take-over or other growth strategies, can be measured. The board must ensure that all of the bank’s activities are monitored and measured against such a framework. In Northern Rock and HBoS, this would have meant that if the funding strategy had been based on short term funding, the board should have set controls.

## **Remuneration and Culture**

A consequence of the pursuit of profit and growth is that this was reflected in the remuneration within banks. Targets were short-term and based on financials only. The variable part of the remuneration package was by far the largest component and cash based. This exacerbated the cultural problems within the banks. The reason for taking high risks is the of gaining high rewards. The employees within the bank at all levels would pursue such a strategy. The high rewards lead to the question how staff remuneration and their targets should be linked. The pressure on return on capital from the new regulation makes it more important to achieve sufficient returns to keep the bank a viable business. Financial targets

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Financial Services Authority, ‘The Failure of the Royal Bank of Scotland’ (December 2011) <<http://www.fsa.gov.uk/pubs/other/rbs.pdf>>

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Basel Committee on Banking Supervision, ‘Principles for Enhancing Corporate Governance’ (October 2010) <<http://www.bis.org/publ/bcbs176.pdf>>

might be most important to the shareholders, but the way in which they are achieved is important to other stakeholders.

One way of tackling this problem is to set regulatory restrictions on variable pay within UK banks. This is done by CRD IV which in this respect differs from Basel III, which it seeks to implement. From 1 January 2015, the variable component is capped to the level of the fixed component for staff captured. This includes senior management, risk takers, staff engaged in control functions and anyone else whose salary and risk profile takes them to that level. Only with sufficient shareholder approval might this ratio be raised to twice the level of the fixed component. Equally important are the requirements to include clawback provisions of variable pay in case of conduct resulting into losses or failing to meet the standards of fitness and propriety. These provisions need to have some more teeth. Firstly, fixed pay levels will raise as a result of these provisions.<sup>1084</sup> This means that the level of remuneration remains unchanged. Secondly, if the variable part is reduced the clawback will cover a smaller part of the remuneration. Thirdly, awarding remuneration, especially variable remuneration, should be linked to targets that measure the conduct and the employee's standards of fitness and propriety. The closest CRD IV comes to moving away from financial performance targets is in Article 94(1)(a) where it states that for assessing individual performance, financial and non-financial criteria should be taken into account, and in Article 94(1)(k) where it states that all types of current and future risk shall influence the variable remuneration. The mandatory inclusion of risk is a good start. It forms a balance for financial performance targets.

### **Board Effectiveness and Senior Management Experience**

The effectiveness of the board is of paramount importance. In the case study of US, it was that many of the boards were ineffective, if only they were composed of sometimes as many as forty people. Some of the measures taken to improve the effectiveness of these boards were: to stimulate reduction in size; the introduction of outside, independent non-executive directors; and to introduce committees with responsibility for nomination, remuneration and audit. Other measures to align the interests of the board with those of the shareholders include the introduction of option award schemes.

The deeper reason for the failure at RBS was the lack of effectiveness of board oversight and challenge. These failures of effectiveness include: the failure to challenge the focus on increasing revenue and assets; the failure to identify the aggregate risk across the businesses; and the failure to challenge assumptions underlying the business model, including those behind the US subprime market and behind the funding market. This was problematic when combined with the leadership capability and management style of Fred Goodwin. It was concluded that his management style deterred robust challenges from the board. Similar problems of an ineffective board emerged from the case study of HBoS. The board regarded itself as a beacon of good governance, resulting in complacency rather than detailed scrutiny

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Financial Times, 'City bankers to evade EU bonus cap with role-based allowances' (13 April 2014) <<http://www.ft.com/cms/s/0/02213446-c19d-11e3-b95f-00144feabdc0.html#axzz3bApKRGyx>>

of how the bank was run. It was combined with a lack of banking knowledge on the board, which reduced its effectiveness in challenging any decisions. The situation at RBS and HBoS confirms the importance of an active board that challenges the decisions taken. This is the point highlighted earlier from the US case study. It emerged from the case studies of Northern Rock and Barclays. The effectiveness of the board of banks was one of the areas covered by the Walker Review. Instead of amending the Companies Act 2006, the Walker Review suggests that much can be done within the framework, including ensuring sufficient knowledge exists within the board. It is suggested that the FSA, now the FCA, must ensure that the nonexecutive directors commit sufficient time, engage proactively in board discussions and act in line with the risk strategy. This means that the FCA must monitor the directors monitoring the senior management. Although the FCA under the Financial Services and Markets Act 2000 has its approved persons regime and it has a dialogue with the banks' boards, it would seem a stretch to suggest that this is sufficient to ensure an effective board. To make the board more effective, various measures have been implemented to improve the accountability of the board in case of failure.

### **Senior Management Regime**

The amendments made by Financial Services (Banking Reform) Act 2013 to FSMA 2000, in particular s64A and s66A, which come into force on 7 March 2016, do have teeth. The FCA and PRA have a joint consultation paper out on this Senior Management Regime. Under s66A, the FCA can find a senior manager guilty of misconduct contrary to rules of conduct defined under s64A. The action that the FCA can take against individuals in these cases is specified under s66 and include: a fine; publishing a statement of his misconduct; suspend its approval; and limits or restrict the functions the individual may undertake. There is a much greater chance that an offender will be subject to action under these provisions compared with the regime under s36. The question is whether such regulatory action may form a sufficient deterrent which will stimulate the board to operate better and more effectively. There are sufficient roles a disgraced bank manager could perform, consider the speaking circuit or consultancy and advisory roles. The effectiveness of the board can be increased by implementing appropriate information control systems. From the Lloyds case, it was that divisions underestimated their risk. In the case of RBS, it was found that the quality of risk control and management information was lacking. The problem of inadequate risk and control systems was aggravated by an increasing level of complexity in the activities and products in which the bank engaged. In the period leading up to the financial crisis there had been an increase in complex financial instruments. As a consequence of the capital requirements introduced by Basel II, there had been a large growth in the securitisation market. This created leveraged products based on loans and mortgages, which allowed banks to transfer the risk of losses to the buyers. It formed part of a trend towards more complex products and derivatives, where pay-off structures are leveraged and depend on some underlying benchmark or security, such as an exchange rate, interest rate or share prices. The rise of these products is not wrong, apart from their use to avoid capital constraints. But what it does mean is that everything in the bank has to be lifted to a level capable of defining the strategy and monitoring and controlling the risks relating to these products. Senior management needs to provide sufficient guidance in its business strategy.

## Recommendations for External Corporate Governance

The financial crisis affected individual institutions and reasons that allowed these trigger events to be exacerbated into the financial crisis. These two categories of problems require different consideration. The first category stems from decisions taken at individual firms, even though many banks had made the same problematic decisions. It contains overexposure to the US subprime mortgage market and a poorly construed business model. The second category relates to systemic risk in the financial system and the fear of contagion. Several banks had become too-big-too-fail and the inter-connectedness in the financial system had increased. This means that if a large bank would fail, it would have repercussions throughout the system, causing a domino effect amongst other banks. One of the responses<sup>1085</sup> to the G20, in order to reduce the systemic risk in the financial system was to address the opaqueness caused by the growth of over-the-counter products. Although whether the creation of these CCPs has reduced the systemic risk or concentrated it with these CCPs is a much-debated question. It was suggested to strengthen capital and funding requirements to prevent bank failure. This is covered by Basel III and, within the EU, by CRD IV. In the UK, the reduction of systemic risk was explored by the Independent Commission on Banking<sup>1086</sup>.

## Recovery and Resolution

If deposit holders fear that their savings are no longer secure then this will trigger a run on the bank. This was presented in the case study of Northern Rock, which was done under the Banking (Special Provisions) Act 2008. The step towards allowing an orderly failure of a bank must be the safeguarding of deposits. This has been implemented by way of the Financial Services Compensation Scheme (“FSCS”).

Another part of resolution regime is that it would allow for a failure whilst minimising its impact on the economy and without requiring state support. The Special Resolution Regime forms part of the Banking Act 2009, goes a long way in achieving this. It grants sweeping powers to the regulators, especially to the Bank of England, to intervene and transfer parts out of the failing bank or to trigger a bail-in. These powers come with appropriate limitations, linked to the objectives of the powers, and with appropriate rules on compensation of parties affected. The effectiveness of these new powers will be tested in case of a future bank failure. They are an improvement on the situation before the financial crisis, when no resolution regime was in place. Its absence contributed to the problems around the failures during the crisis, including the capital injection by the government and the resulting state-ownership. If one accepts that bank failures will happen, it is important to

<sup>1085</sup>

Basel Committee on Banking Supervision, ‘The Basel Committee’s Response to the Financial Crisis: Report to the G20’ (October 2010) <<http://www.bis.org/publ/bcbs179.pdf>> accessed 20 November 2015

<sup>1086</sup>

Independent Commission on Banking, ‘Final Report – Recommendations’ (September 2011) <[http://www.ecgi.org/documents/icb\\_final\\_report\\_12sep2011.pdf](http://www.ecgi.org/documents/icb_final_report_12sep2011.pdf)> accessed 20 November 2015

focus on drafting an appropriate resolution regime as it is to draft adequate capital requirements. It is of equal importance that banks diligently prepare their recovery and resolution plans. The PRA has issued a statement on how it expects banks to do this, besides the relevant parts of the rule book and the relevant directives.<sup>1087</sup> The PRA expects these reports to contain a series of options for the bank, depending on the type of stress it is under, addressing severe capital or liquidity difficulties.

## **Fair Treatment of Clients and Customers**

Since the financial crisis, various cases of misconduct by bank employees has been reported. This misconduct relates to points made previously when discussing internal corporate governance, especially in relation to culture, remuneration and the prioritisation of growth and profit. Most of these have resulted in heavy fines for the banks and individuals involved, as well as damage to the sector as a whole. These failures of bankers' conduct include the miss-selling of products, including PPI and interest rate swaps, money laundering and violating international sanctions, rogue traders and market manipulation. The regulators and other law enforcement agencies have come down hard on the financial institutions involved, handing out record fines. Some of the individuals involved are facing criminal prosecution.

The Fair and Effective Markets Review conducted a review of the practices in the fixed income, currency and commodity markets in wake of the LIBOR and FX scandals.<sup>1088</sup> The report includes observations, including a market structure presenting opportunities for abuse, failings of internal governance and controls and poorly designed remuneration and incentive schemes. The review makes several recommendations, including increased individual accountability, especially with front-line staff; making the market itself collectively responsible for maintaining high standards; and maintaining a credible deterrence for when standards do slip.<sup>1089</sup> The report recommends that the senior management regime, which was introduced for banks following the crisis, is extended to cover all companies which operate in these markets. The point in all scandals is that the people involved, whether traders rigging rates or retail sales staff miss-selling PPI, had a personal financial incentive to do so. In the case of the traders, the manipulated rates showed their trading positions in a more favourable light. This would affect their variable pay at the end of the year. In the case of a retail sales network, the targets are set in terms of selling a new product. It should be noted that PPI in itself is not a bad product and some people need it. Selling it to anyone because

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Prudential Regulation Authority, 'Recovery Planning: Supervisory Statement SS18/13' (16 Jan 2015) <<http://www.bankofengland.co.uk/prd/Documents/publications/ss/2015/ss1813update.pdf>>

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HM Treasury, Bank of England, Financial Conduct Authority, 'Fair and Effective Markets Review, Final Report June 2015' (2015) <<http://www.bankofengland.co.uk/markets/Documents/femrjun15.pdf>>

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Tracey McDermott, 'Fair and Effective Markets Review' (2015) <<https://www.fca.org.uk/news/fair-and-effective-markets-review>>

this product needs to be pushed and it is profitable, is not appropriate. External stakeholders must be recognised and included in the targets and objectives set to staff.

The outcome of the scandals has been record fines for the banks involved. These fines are part of a settlement with the enforcement agency, which include a discount on the fine and immunity from criminal prosecution. The fines are passed on to the shareholders of the bank as they reduce profit and reduce dividend payments. The regulator may get worried about the height of the fine as it could have a negative impact on the capital position of the bank. This reflects the importance of the important banks. Consider action brought against institutions that were not important. Companies such as Arthur Andersen, WorldCom or Enron have all become insolvent. In 2002, Arthur Andersen, one of the world's largest accounting firms, was found liable in relation to its handling of Enron. Both WorldCom and Enron were engulfed in scandals and filed for bankruptcy. It seems wrong that, because a bank is deemed too-big-too-fail it should be allowed to escape criminal liability and continue to operate as normal.

## Ownership

Shareholders can be rather passive. At Northern Rock, it was not just the directors and the risk committee that had failed. The board had communicated its funding strategy to its shareholders. It would appear that either the shareholders had not scrutinised the plans themselves, or, if they had, then they had accepted the high risk in return for the promise of a high reward. It is also a concern that some of the shareholders were employees. One would have expected them to scrutinise the business strategy in great detail as it affects not only their employment but also their capital. The employees had to the usual channels available for employees, an additional way to express their opinion on the strategy as shareholders. One may point out the rough analogy with Lehman Brothers, where employees had their pension and savings invested in the firm, failed to scrutinise the business strategy and challenge it. At RBS, the situation was worse. The shareholders supported the disastrous take-over of ABN Amro.<sup>1090</sup>

One may state that the shareholders have invested their own money and, should things go wrong, they lose it. This is what happened with the shareholders of the UK banks that failed. This is answered by the UK Stewardship Code for institutional investors, one of the aims of which is to promote the long-term success of companies in such a way that the providers of capital prosper.<sup>1091</sup> The interests of the shareholders and other stakeholders in the banks are aligned. It may well be possible that these guidelines, which are operated on a comply or explain basis, need to be strengthened for investments in financial institutions. This would recognise the importance of the stakeholders and the role of banks.

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<sup>1090</sup>

Reuters, 'RBS investors back ABN deal' (10 August 2007) <<http://www.reuters.com/article/2007/08/10/us-abn-takeover-rbs-vote-idUSL1076842520070810>>

<sup>1091</sup>

Financial Reporting Council, 'The UK Stewardship Code' (September 2012) <<https://www.frc.org.uk/getattachment/e2db042e-120b-4e4e-bdc7-d540923533a6/UK-Stewardship-Code-September-2012.aspx>>

Within the UK, the regulator best placed to perform this task is the FCA. In a response to the proposals by the Parliamentary Commission on Banking Standards, the FCA went out of its way, not only to outline the tools it had, but to point out its existing focus on supervision of standards, governance and culture.<sup>1092</sup> The FCA's Director of Enforcement and Market Oversight, Mark Steward, delivered a speech on culture and governance.<sup>1093</sup> The problem is that although the regulator can draw up rules and standards, which describe the expectations and the boundaries, they do not create a situation in which good governance magically appears. He describes several things that are needed to achieve this, the one being knowledge and expertise at senior management level.

### **Core governance principles**

Most capital markets have adopted more or less similar core governance principles to safeguard investors' interests even though they may differ in their choice for the shareholder or stakeholder models. Common corporate governance practices tend to focus on corporate transparency, board compensation policies, management succession planning, protection of minority interests, risks management, performance and conformance, and increasingly nowadays other stakeholders' interests. This study with particular focus of the banking and finance sector supports the ongoing insights that corporate governance problems surrounding conflicts of interests still persist because of the general effects of board compensation structures and incentives, financial gatekeepers' inadequacies, various limitations of existing soft and hard laws, and other reasons. The study finds that despite additional rules and regulations surrounding banking operations, the sector is not spared from the excesses found in other corporate sectors. This is worrying as banking and finance exert widespread effects on the entire economy due to the nature of its services. In the final analysis, whilst macroeconomic factors are uncontrollable, the banking and finance sector should ensure that the more controllable corporate governance practices are held to very high standards to minimise the risks of corporate misfeasance and malfeasance. Only then can the sector deliver sustainable performance free from scandals and the like. Future legislation should take into account guiding principles such as the following: avoid over-regulation and unwarranted increase in compliance costs; ensure, only to the extent necessary, legal and regulatory certainty through firm harmonization measures across the European Union; avoid placing undue reliance on institutional investors as the sole substitute for good management and director supervision; avoid measures which would encourage the creation of an inefficient, litigious environment; clarify executive and nonexecutive directors' duties within

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<sup>1092</sup>

Financial Conduct Authority, 'Tackling Serious Failings in Firms: A Response to the Special Measures Proposal by the Parliamentary Commission on Banking Standards' (June 2014) <<https://www.fca.org.uk/static/article-type/news/tackling-serious-failings-in-firms.pdf>>

<sup>1093</sup>

Mark Steward, 'Culture and Governance' (11 November 2015) <<https://www.fca.org.uk/news/culture-and-governance>>

the board and the board committees; avoid placing undue reliance on auditors and actuaries as solely responsible for detection of accounting and corporate governance irregularities.<sup>1094</sup>

Maximizing the competitiveness of capital markets is critical to ensuring economic growth, job creation, low costs of capital, innovation, entrepreneurship and a strong tax base in key areas of the country. Regulation and litigation play central roles in protecting investors and the efficient functioning of our capital markets, in light of highly publicized abuses. Excessive regulation, problematic implementation and unwarranted litigation when occurring simultaneously make capital markets less attractive and less competitive with other financial centers around the world. As shareholders are able to take more control over companies in which they are stakeholders, regulation can be more targeted.<sup>1095</sup>

### **Market competitiveness**

Capital markets have been the deepest, most liquid financial markets in the world. As a result, companies have had access to funding with the lowest cost of capital. Foreign issuers have come to public markets for the same reasons, as well as for the quality of market regulation. Foreign entities did not have viable public market alternatives elsewhere in the world. The world is different because there are viable choices. Where there was once only one viable market, there are several such markets. Technology provides the possibility of easily trading anywhere. Because multiple markets have created choices that never used to exist, issuers seeking capital are using a cost benefit analysis that focuses on the competitive differences between markets, including the potential cost of litigation and the complexity of regulation. Public capital markets must compete for business in a global market place. Access to capital is no longer a competitive advantage. Modern technologies can significantly help members and third parties to exercise their rights effectively. At a minimum, company law should enable and encourage as much as possible the use of up-to-date information and communication technologies by companies in their various relationships with members and third parties.<sup>1096</sup> Business efficiency and competitiveness, which are crucial components of economic growth and job creation, depend on many factors,

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Iatrou, A., 'European Response: The European Union's Corporate Governance Standards will impact insurers as investors and as providers of coverage to corporations', (2003), Industry Strategies, available in the website: <http://www.thefreelibrary.com/European+response:+the+European+Union%27s+corporate+governance.-+a0111111958>.

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source: [http://www.capmksreg.org/pdfs/Summary\\_11.30interimreport.pdf](http://www.capmksreg.org/pdfs/Summary_11.30interimreport.pdf)

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European Commission, Communication 0284/2003 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward', available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.



one of which is a sound framework of company law.<sup>1097</sup> Flexibility should be available to companies as much as possible: where systems are deemed to be equivalent, maximum room should be left open to the freedom of the parties involved.<sup>1098</sup>

### **The impact of regulations and litigation**

A substantial portion of the erosion in markets global and internal competitiveness - and the only factors over which policymakers have control - relates to insufficiently coordinated, costly and/or excessive market regulation and enforcement, public and private. Regulatory requirements for complying with Section 404 of the Sarbanes-Oxley Act cost companies, on average, \$4.36 million in the first year - a stiff price for most public companies and a significant burden for small ones, particularly first-time market entrants. Nearly open-ended responsibility of auditors in complying with Section 404 has made a consolidation-shriveled profession virtually uninsurable for this work.

## **Future Developments**

### **Addressing the Weaknesses**

It is acknowledged that they are of increased importance in a bank, but they are elements of corporate governance. The approach to tackle these weaknesses should emerge from strengthening corporate governance rather than introducing measures specific to banks. Given the impact of the financial crisis, it seems reasonable to question whether a corporate governance code can operate on a comply-or explain basis. If one wants to address the weaknesses, such a code needs to be enshrined in legislation, adhered to and monitored. An argument holds for board reform, it is a point of corporate governance, which in case of a bank amplifies. Instead of focussing on gender quotas, important this might be in itself, it would be wise to ensure that a board has sufficient knowledge and experience to challenge senior management. In the case of banks, the regulators need to approve new board members and these rules have sharpened up. In light of the serious failings in board effectiveness during the crisis, it is necessary to introduce general guidelines or requirements on board members. The cultural problems in banks are difficult to resolve. Changing the culture within an organisation or company takes several years. It appears that the culture of an industry needs to change. This is concerning as some of the most effective measures on remuneration come from the EU, which the UK may well leave in the near future.

### **State-ownership**

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<sup>1097</sup>

European Commission, Communication 0284/2003 'Modernising Company Law and Enhancing Corporate Governance in the European Union - A Plan to Move Forward', available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.

<sup>1098</sup>

European Commission, Communication 0284/2003 'Modernising Company Law and Enhancing Corporate Governance in the European Union - Plan to Move Forward', available in the website: <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52003DC0284:EN:HTML>.

The government created UKFI to deal with its investments at arm's length. This was a struggle as it would be difficult for politicians to resist meddling in the day-to-day affairs of the state-owned banks. This is understandable when the annual bonus round would come along and the media headlines would be dominated by payments made in the bailed-out banks. However, the meddling has proven undesirable. The objectives of the politicians are incompatible with those of the banks and of the regulators. The politicians want the banks to lend more to stimulate the UK economy.

## **Future Research**

### **a. Corporate Governance at Banks as a Special Case**

Corporate governance at banks is seen as a special case of corporate governance. The reasons for doing so are that it includes more regulation and supervision; it has a greater emphasis on risk management; and it has debt management. These differences apply to what constitutes internal and external corporate governance at banks. Internal governance and controls at banks may include a good corporate culture, behaviour and risk management. External governance and controls at banks will include the regulators. These special elements attract most attention as well as in practice. It is suggested to have equal regard to the non-special parts of corporate governance at banks. It would be useful to investigate these general, or nonspecial, parts on its own, but also how they interact with and drive the bank-specific elements. Future research could focus on general elements not discussed as part of this research as they did not establish themselves as weaknesses during the crisis, but they may have done so in other corporate crises.

### **b. Comparative Corporate Governance**

The other major comparative element in this research, arises from the fact that much of UK financial regulation is derived from international reports and from EU directives and regulations. When studying corporate governance at UK banks, comparative problems emerging from this are unavoidable. One must consider the context of the international reports of how EU law is made.

## **The future of corporate governance**

Globalization and the multinational character of modern companies have raised a lot of questions about whether there is one method that can safely lead to the much-desired convergence of corporate governance laws. Differences in terminology and multiplicity in the legal concepts have led the legislators to adopt a strategy of common minimum standards, according to which a limited number of topics are harmonized. Such a solution cannot be characterized as successful and has been at the centre of criticism as being a 'fragmentary and compromise solution'.<sup>1099</sup>

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<sup>1099</sup>

Ibid. See Grundmann, S., 'The Structure of European Company Law: From Crisis to Boom', (2004) 5 European Business Organisation Law Review 601.

Mutual recognition, minimum standards and subsidiarity provide a framework for regulatory competition, which reduces the scope for strategic regulation and dilemmas.<sup>1100</sup> Regulatory competition can become unstable if mutual recognition is not achieved. There is always the fear that regulatory competition will end up leading to a race to the bottom if there is no framework to control and regulate it. In the United States, the result has been an ‘uneasy and fluid allocation of corporate law between the federal government on the one hand and the individual states on the other’.<sup>1101</sup> The open method of coordination has been added to the agenda. It is a soft law approach designed to encourage joint action, peer pressure, benchmarking and indicators. It bears strong resemblance to self-regulation, improved with a combination of short, medium and long-term reporting periods. The essence of this approach is the use of centralised regulation to preserve a space for ‘autonomous governance at lower levels of government’.<sup>1102</sup> It deviates from the traditional decision-making process and supports a model of inter-governmentalism. It is doubtful whether the open method of coordination, which has been adopted in the areas of employment and social protection, can be introduced to company law. It faces the same problem that made self-regulation ineffective: lack of sanctions and no supervision cannot guarantee conformity and strong enforcement, because compliance rests upon the discretion of the countries. The experience of the SoX with its ‘trans-territorial impact’ showed that fraud and mismanagement have no particular national identity and that ‘moral standards and value management systems for risk prevention’ are essential in all countries of the world.<sup>1103</sup> The jury may be out as to the long-term prospects for rival systems of corporate governance in an increasingly globalised economy. Even if consensus is attained over ‘universal core moral values’<sup>1104</sup> that need to be a part of every company at any cost, the battle against corporate misconduct is not over. This happens because these rules and values need to be put into practice, to be followed, and to be respected by all parties involved.

The financial crisis confirms the importance of solid corporate regulation to the world economy, and the need for ethical and effective initiatives. It is positive that there was no

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Deakin, S., ‘Two Types of Regulatory Competition: Competitive Federalism versus Reflexive Harmonisation. A Law and Economics Perspective on *Centros*’, (1999) 2 Cambridge Yearbook of European Legal Studies at 258.

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Wieland, J. and Fürst, M., ‘Moral als element der good corporate governance in banken’ [Moral as an element of good corporate governance for banks], in Wagner, A. and Seidel, C., (eds.), *Ethik in der Bankenpraxis*, Bankakademie Verlag, Frankfurt and Main, Germany, 2004, pg. 21-43.

1104

Waddock, S., ‘Creating Corporate Accountability: Foundational Principles to Make Corporate Citizenship Real’, (2004), *Journal of Business Ethics*, Vol. 50, No. 4, 323.

attempt to introduce a brand new legislative framework, but the Ministers tried to create a comprehensive framework, building on existing initiatives, to identify and fill the existing regulatory gaps and foster the broad international consensus needed for rapid implementation. In the Final Statement, they mentioned among other the strengthening of business ethics as one of the Framework's aims.<sup>1105</sup> The business world has suffered too much during the last decades and seems to be determined to avoid the same mistakes that caused the corporate governance failures and provoked the financial crisis. Since the missing link has been identified, an attempt will now be made to evaluate the future of corporate governance regulation after the aforementioned initial responses. The wave of scandals accelerated the procedure and helped in overcoming any second thoughts and reservations. Such a significant and complicated piece of legislation could not be flawless, especially in a period when news of successive failures and collapses was in the newspaper headlines. The crisis is not directly linked with corporate governance as such, but there are some common symptoms: failure to exercise proper due diligence, unsound risk management practices and weak supervision. Moreover, the causes can be traced back to the pre-crisis phase, the tranquillity period. During the period of strong global growth and prolonged stability, market participants sought higher yields without an adequate appreciation of the risks and failed to keep pace with financial innovation, or take into account the systemic ramifications of domestic regulatory actions.<sup>1106</sup> Instead in the middle of the crisis, when circumstances look dire and chunks of the financial system are falling off, proposals get radical. But after each crisis is over, these radical plans are tidied away and what remains is calls for better disclosure, greater transparency independence and risk management. The financial crisis drew our attention to an old lesson that we need to revise.

The field of corporate governance draws from many varying disciplines: law, economics, ethics, politics, management, and finance. In this respect, understanding the issues raised by corporate governance requires familiarity with the concepts, assumptions and terminology of each of these fields, plus a willingness to synthesize and even transcend them.<sup>1107</sup> The mistakes which have been made can be used as a useful guide and point of reference for the future, as, following the right direction, they can show the way that leads to a safer, more dynamic corporate governance habitat. The financial climate changed significantly after Enron and the US Sarbanes-Oxley Act, not only in the United States, but around the world. The quality of a company's corporate governance is seen as vital to its longer-term

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Paul Maidment, 'Lecce Framework Has No Teeth', *Forbes*, 13 June 2009, available in the website: <http://www.forbes.com/2009/06/13/g8-finance-ministers-recession-opinions-lecce-framework.html>; See also, 'The Lecce Framework', *Forbes*, 13 June 2009, available in the website: <http://www.forbes.com/2009/06/13/g8lecce-framework-markets-economy-full-text.html>.

1106

Declaration of the Summit on Financial Markets and the World Economy, November 15, 2008, available in the website: <http://georgewbush-whitehouse.archives.gov/news/releases/2008/11/20081115-1.html>.

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B. Minoru Makihara, Chief Executive of Mitsubishi Corporation, cited in Deakin, S. and Hughes, A., *Comparative Corporate Governance: An interdisciplinary Agenda*, (1997), *Journal of Law and Society*, Vol. 24, No. 1, pg. 8.

performance.<sup>1108</sup> It is clear from the evidence that institutional investors are no longer passive, back-seat owners of companies. They can no longer ignore their responsibilities as shareholders. In the UK, the investment institutions have realized that passive shareholding is not the route to shareholder wealth maximization.<sup>1109</sup> Among public and private institutions in the corporate constellation, only the fiduciary shareholder has interests congruent with modern corporation. By definition, they are long-term investors and they want sustainable growth from companies that provide useful goods and services and good jobs at good wages.<sup>1110</sup>

## Conclusions

To conclude, from different points of view, and based on the failures of the financial institutions such as Barings Bank, Allfirst Bank, BCCI, Lehman Brothers, Northern Rock, WorldCom, Enron as well as Parmalat that are analysed above, it appears that there was inadequate corporate governance and as a result, the organizations suffered severe financial loss and in some cases faced financial collapse. It appears that the corporate governance flaws in the Enron/WorldCom cases led to Sarbanes-Oxley. However, it seems that Sarbanes-Oxley in the US does not appear to be able to deter corporate governance flaws in banking and this is why Dodd-Frank followed. Besides this, the Companies Act 2006 and corporate governance codes appear not to work sufficiently well in the UK, and this is why updated corporate governance codes were launched there. This thesis focuses on corporate governance in banking and the thesis focused primarily on problems in the banking industry. We also discussed the legal implications for directors as well as their duties. It seems that the previous reforms measures are not effective and the current reform measures would work based on evidential support as uncovered by the thesis.

The thesis uncovered were flawed corporate governance practices in the US and UK banking sector are concerned, and we illustrated that these were due to poor management, insufficient monitoring and poor supervision, etc. The general effectiveness of financial regulatory reforms in the US and UK could be strengthened according to the following findings and recommendations. Corporate governance practices are weak in the US and UK banking sector, therefore we are going to suggest how these could be strengthened. In the first place, sound corporate governance is reliant on external marketplace commitment and legislation plus a healthy board culture which safeguards policies.<sup>1111</sup> The succession of corporate scandals before the dawn of the new millennium revealed that corporate governance

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Bob Tricker, *Corporate Governance, Principles, Policies, and Practices*, third edition, Oxford University Press, 2015, pg. 450.

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Jill Solomon, *Corporate Governance and Accountability*, fourth edition, Wiley, United Kingdom, 2013, pg. 352.

1110

Robert A.G. Monks & Nell Minow, *Corporate Governance*, fifth edition, Wiley, United Kingdom, 2011, pg. 484.

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structures needed to be improved and reinforced. Legislation can provide a framework of operation and a set of basic rules, but modern companies need to undergo a deep change in their culture, in order to stay away from fraudulent practices and unethical conduct. Christopher Stone examined the culture of the corporation in 1975 and was realistic in assuming that the dominant orientation of companies will remain toward profit, expansion, and prestige.<sup>1112</sup> His suggestion was that we cannot rest upon anything firmer than the corporation's good intentions, but we need to fight the pre-existent corporate cultures, so that no underlying attitudes remain untouched. The business environment was not yet ready to welcome and adopt such far-reaching proposals. Kydland and Prescott had emphasized the importance of pondering not only the desirable policy for a given set of circumstances but also the framework likely to produce the best policy over time.<sup>1113</sup> The focus should be in the long-run, with a view to creating a consistent policy<sup>1114</sup> and policy makers should behave in a systematic way focusing on the achievement of their long-term goals without short-term deviations. The search for a good policy rule should be limited to a comparison of alternative policy rules in order to select the one with the most attractive operation characteristics.<sup>1115</sup> The issue of short-termism in corporate objectives had been addressed and it has been highlighted as one of the most significant factors contributing to excessive risk-taking.<sup>1116</sup> Proposals were stressing the importance of having management interests aligned with the long-term sensible interests of the companies, in an attempt to find a common point of reference for everybody's legitimate expectations. In this way, excessive risk-taking could be avoided and there would be incentives for safe, and sound behavior<sup>1117</sup>,

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Stone, C. D., *Where the Law Ends: The Social Control of Corporate Behavior*, Harper & Row Publishers, New York, 1975, pg. 230 and 236.

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Buol, J. and Vaughan, M., 'Rules vs. discretion: the wrong choice could open the floodgates', (2003), *The Regional Economist*, Issue January, pg 10.

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Kydland, F.E. and Prescott, E.C., 'Rules Rather than Discretion: The Inconsistency of Optimal Plans', (1977) *Journal of Political Economy*, Vol. 85, pg. 473-491.

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Buiter, W.H., *Macroeconomic theory and stabilization policy*, Manchester University Press, Manchester, UK, 1989, pg. 95. See Prescott, E.C., 'Rules rather than Discretion: The Inconsistency of Optimal Plans', (1977), *Journal of Political Economy*, Vol. 85, 473-491.

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Bebchuk L. and Fried, J., *Pay without Performance: The Unfulfilled Promise of Executive Compensation*, Harvard University Press, Cambridge and London, 2004;Bebchuk, L., Fried, J. and Walker, D., 'Managerial Power and Rent Extraction in the Design of Executive Compensation', (2002), 69 *University of Chicago Law Review* 751-846; Bebhuk, L. and Fried, J., 'Executive Compensation as an Agency Problem', (2003), 17 *Journal of Economic Perspectives* 71-92; Bebhuk, L. and Fried, J., 'Pay without Performance: Overview of the Issues', (2005), *Journal of Applied Corporate Finance* 8-22.

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Bernanke, B. S., Chairman of the Federal Reserve System, 'The Financial Crisis and Community Banking', speech at the Independent Community Bankers of America's National Convention and Techworld, Phoenix, Arizona in March 20, 2009, available at the website: <http://www.federalreserve.gov/newsevents/speech/bernanke20090320a.htm#fn3>.

as an individual's performance would be evaluated over time together with the company's long-term interests. The business world was obliged to change its strategy and ethics could guarantee a smooth transition into a new era where doing business is based on values, principles, long-term perspective and accountability. An ethical culture can be the missing link for the future of corporate governance, as well as the key for the successful reform of the existing regime. Corporate and personal ethics can become an efficient substitute for external regulation and internal control within the companies provided that corporate leaders are effective in implementing the business strategy and ethical vision of their companies.<sup>1118</sup>

The thesis has highlight various corporate governance theories, however, the communitarian approach is a basis for regulation. The thesis gathers key insights from previous corporate and financial crises concerning flawed corporate governance practices (in particular with respect to risk-taking and directors' remuneration) that contributed to the emergence of these crises. These developments prompted regulatory responses in the US, UK and elsewhere including the justification for a more global response. The examination of these regulatory responses suggest further/potential areas for strengthening as suggested in the thesis and for which future research work could be explored.

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